SOCIAL SECURITY: DEFINING THE PROBLEM

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CONTENTS

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WEDNESDAY, FEBRUARY 9, 2005

HOUSE OF REPRESENTATIVES,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to call, at 10:07 a.m., in room 210, Cannon House Office Building, Hon. Jim Nussle (chairman of the committee) presiding.

Members present: Representatives Nussle, Portman, Crenshaw, Putnam, Wicker, Hulshof, Bonner, McCotter, Diaz-Balart, Hensarling, Lungren, Ros-Lehtinen, Bradley, McHenry, Mack, Conaway, Simpson, Spratt, Moore, Neal, DeLauro, Edwards, Ford, Capps, Baird, Cooper, Davis, Jefferson, Allen, Case, McKinney, Cuellar, Kind, and Schwartz.

Chairman NUSSLE. Good morning, and welcome to this Budget Committee hearing on Social Security long-term budget implications. We also have the opportunity today to talk a little bit about the economy. We have before us on the first panel, the very distinguished and honorable Treasury Secretary John Snow who has been before our committee before. We welcome you back to the Budget Committee. We are pleased to have the opportunity today to talk about a myriad of issues and subjects that—you as one of the principal advisers to the President with regard to a number of subjects, not the least of which of course is the economy, is an opportunity that we take very seriously.

On our second panel today we will have the U.S. Comptroller General David Walker and the Director of the Congressional Budget Office, Douglas Holtz-Eakin. They are here today to discuss the analysis of their respective agencies with regard to the challenges facing Social Security.

On the third panel we have Peter Orszag, who is a senior fellow at the Brookings Institute.

We are also pleased today to welcome a new member to the Budget Committee, Mike Simpson, we are welcoming you from the Appropriations Committee. As we all know, because this is a leadership committee, we accept members from a number of panels as a subcommittee slot, and we appreciate the sacrifice you are making in coming over here and in joining our humble crew from the Appropriations Committee. Welcome.

We also understand, if I am not mistaken, Mr. Spratt, that you will be welcoming another member as well. We want to yield to you for that purpose so you can make that introduction.

Mr. SPRATT. Thank you, Mr. Chairman. I don't see her here, but Allyson Schwartz will be coming. She has just been approved for

membership on this committee by the Democratic Caucus. Oh, that was good timing. Allyson Schwartz from Philadelphia, Pennsylvania.

Chairman NUSSLE. We welcome you to the Budget Committee.

Mr. SPRATT. Is this seat here open?

Chairman NUSSLE. That is the unfortunate thing, we show you the last seat on the panel. But welcome to our new members of the Budget Committee. We are pleased to have your involvement on our committee.

To begin with, I want to make it clear that the purpose of this hearing is probably not today to write a bill. I understand that there is a lot of interest in coming forward and saying, let us skip to the last chapter of the book and write the plan, let us get on with it; but we have a lot of consideration, I think, to make before we get to that point in time. We are not here to try and evaluate specific reform proposals because there aren't many to choose from just yet. We have a lot of work just defining the problem—just kind of getting our arms around it. We know there is a challenge out there for Social Security. I think most reasonable people who look at the numbers would suggest that.

In part by holding this hearing, we are trying to help prepare the debate by examining and defining the problem itself so we as policymakers on the Budget Committee, as well as just Members of Congress, can begin to discuss this issue—base any plans for reform on a solid understanding of what it is or what it is not as a challenge, and what is possible within the Federal budget and the parameters that we have before us.

It is clear from some of what you might call rhetoric, that is flying around here lately, that today's hearing is probably a pretty necessary step in helping to dispel some of the apparent confusion and misinformation around the debate. I think we know pretty well that, at least from my colleagues on the other side, every chance they get to say the word "privatization," I think you are going to hear that word probably today and forever and ever. Everyone wants to use that word. Let us go out and use that word because it seems to poll well if you want to scare people about what we are going to do with Social Security in the future. Well, I haven't seen anything yet that smacks of privatization in the way most people I think look at that term. In fact, even the revolutionary thought of allowing people to control even a part of their own savings I think at best you could say is personalization rather than privatization. But I will let people have that rhetorical debate because that seems to be the interesting part.

Even before we talk about those specific issues and solutions, we need to I think discuss the challenge itself—and I thought the President did a good job of doing that in his basic, as simple of terms as possible—why is it that Social Security is facing such a large shortfall in the future? So I will try in a humble way to lay it out as well as I can today.

Back when Social Security was created, far less was demanded of it than it is today. People didn't live as long and thus drew benefits for a shorter amount of time. The benefits themselves were much lower. And for every one person drawing benefits out of the system, there were some 16 workers paying into the system. Today,

50 years later, things are a little different. Back when Social Security was created, the average American's life span was 62 years. Today, it is an average, thank goodness, of 77 years. So we are living longer, we are drawing benefits for a longer period of time, about 15 years longer than when the program was first put into place. Plus, the benefits themselves are scheduled to rise dramatically over the next number of decades. So today, instead of those 16 workers paying in for every beneficiary, we now have about 3. As I understand it, that number falls to about 2 over the next couple of decades.

So there is the short answer to why Social Security is heading for some problems, challenges, crises, depending on that word that—who knows how it polls well, but we know that there is a challenge out there, a challenge that we have to deal with.

So now let us take a look at where that gets us. By 2018, as we are going to hear today, I think quite often, Social Security will be paying out more than it takes in. That is a shortfall in a little over a decade and unless we make some necessary changes, the shortfall will grow larger every year after that. Let me make it clear, this doesn't just start happening in 2018, as I understand it, the challenge begins today and has been going on for quite some time. If we stay on the current path, by 2033, the annual shortfall will be about $300 billion per year. By the year 2042, the entire system in fact by most people's definition of the word "bankrupt" would be bankrupt.

So, in a nutshell, Social Security is threatened by a looming fiscal imbalance that if left unaddressed will impose growing burdens on the budget, on the economy, and on the people it was meant to assist. For us to get to the point where we can even think about finding a so-called solution, we had better make sure that every Member of Congress on both sides has a crystal-clear understanding of the challenge that lays ahead. Again, it is pretty apparent that that is not necessarily the case.

So, again, that is the reason for us to be here today to begin that discussion. Let us all try and do our best to stay focused on this. Now, I understand that there will be many different solutions that will be put forward by many different quarters. They are all responsible, they are all credible, and they all deserve our consideration. They shouldn't be just lambasted out of hand without consideration, and they should be taken in total, as I see it, in the total picture of what retirement security is for an individual.

You know, I don't know about the people that you represent but Social Security doesn't make it for most people in and of itself. Social Security is part of retirement security. If you are going to retire and feel secure, you have got to have health care, you have got to have savings, you have got to have investments that are working. You have got to have an economy that is growing. You have got to have long-term health care. You have to be able to make sure your veterans' benefits are there, and you have got to make sure your housing is secure. You want to live in a safe environment. You want to live in a safe community and neighborhood.

So when you talk about living in a secure retirement, if you only focus on Social Security, I think you are missing the point. It is an important part of it for those who depend on it, certainly, and all

of us recognize that and all of us believe that. I believe it should be looked at in a much larger context, so today we are going to focus on that.

As I said yesterday, the easiest job in Washington is to say, no, that is not going to work; no, I don't like that proposal; no, we are not going to do it that way. That is the easiest thing to do. But we weren't elected to say no. Inaction is not in my opinion a solution to this very vexing challenge. So we have to begin that process today. So I would like us to focus on that problem.

That is the purpose behind the hearing. We are very pleased to have I believe the administration's point person with regard to Social Security, the challenges of retirement security, and the economy before us today to discuss those issues. I focused on Social Security in my opening comments, but I know that we are very interested to hear as well how the economy is doing. We heard yesterday it is doing quite well. That is an important factor in us getting back to a balanced budget and dealing with the myriad of challenges that face our budget and our economy and the people that we represent. So we are pleased to have you before us today.

With that, I am honored to turn it over to my friend, Mr. Spratt, for any comments he would like to make.

Mr. SPRATT. Thank you very much, Mr. Chairman.

And, Mr. Secretary, welcome again. We appreciate you coming.

It has been 4 years since President Bush first sent the budget up to Congress. At the time we received his first budget, the budget was in surplus left over from the previous administration. That weekend after the budget came, the President made a radio address describing his budget, and I made the response to his Saturday morning address. And in my response, I implored the President to use some of the $5.6 trillion surplus then projected to deal with our long-term liabilities. I said, Mr. President, we may seem to be sitting on an island of surpluses, but we are surrounded by a sea of red ink. Not surprisingly, the President didn't take my advice. He committed $1.7 trillion of the surplus to tax cuts, nothing to long-term liabilities, and today we see the consequences.

Frequently in discussing Social Security, people develop in looking at these 75-year projections a notion of futility that the amount of money needed to make the account solvent is just overwhelming and unattainable. This simple bar graph shows that in choosing tax cuts over Social Security reform, there is enough money in the tax cuts for the top 1 percent to make Social Security solvent. Almost enough money; $3.4 trillion as opposed to $3.7 trillion, which is the actuary's number for the present value of the shortfall in the Social Security account.

But we didn't get anything done about that long-term liability 4 years ago. But the Office of Management and Budget (OMB), the Director, Mr. Daniel, did assure us that there would be a threshold condition—his word, a threshold condition—for every budget they submitted. He assured us that no budget they submitted would ever invade the Social Security surplus. That was the threshold condition.

If you recall, the Clinton administration had moved the budget into surplus for the first time in 30 years. And when that surplus reached $236 billion in the year 2000, both parties in Congress,

both sides of the aisle began to talk of a lockbox in which to keep the Social Security surpluses so that never again would those surpluses be used to buy new Government bonds and fund Government spending. We wanted to use the surplus to buy and retire outstanding Treasury bonds. Congressional Budget Office (CBO) told us that if Social Security followed this strategy diligently buying up outstanding bonds, then some $3 trillion in Treasury debt held by the public could be bought back, retired, over the next 10, 12 years.

Now, the lockbox had a corny name, I will grant you, but underlining it there was a serious idea. Each dollar of Treasury debt retired would be a dollar added to net national savings. That would in turn lower the cost of capital, and that in turn would spur economic growth. And, furthermore, when the baby boomers began to retire, the Treasury would be burdened with far less debt and be much stronger to meet the obligations, the long-term obligations of our Government, specifically Social Security.

Well, the $5.6 trillion surplus was soon dissipated and replaced by ever-increasing deficits, $375 billion in the year 2003, $412 billion last year, 2004, and $427 billion OMB tells us this year 2005. In each of these years, the Social Security surplus was borrowed and spent in toto, all of it. So much for the lockbox. Instead of paying off debt, this administration has built up debt, a mountain of debt.

As this next table shows, the Treasury, the administration, who had to come to Congress three times in the last 4 years to ask for the legal ceiling on what the Government can borrow, how much debt we can incur, to ask that the debt ceiling be raised three times: $450 billion in 2002, $984 billion in 2003, $800 billion last November, a total of $2.234 trillion. At that rate, today we are incurring $1 trillion of additional debt of the United States every 18 months. Surely this is not a sustainable course.

Now you decided that Social Security will be broke soon and needs fixing. But the solution that you are pushing, private accounts, really does little if anything to fix the solvency of the system. And by allowing payroll taxes to be diverted from the Social Security Trust Fund into private trust accounts, you add $4.9 trillion to the deficit over the first 20 years, by our calculation, $4.9 trillion to deficits over that 20-year period and to the national debt during that time, to be stacked on top of other debt that could easily reach $12 trillion within the next 10 years. Surely there is a limit somewhere.

In pushing this proposal, the administration described Social Security in dire if not crisis condition, in need of urgent attention. You say that in 2018 Social Security will go cash negative. The Chairman just said it would hit a shortfall. Well, in one sense that may be true, but it is also true that Social Security at that point, 2018, will be sitting on a trust fund of over $2.5 trillion in Government bonds, and that corpus will increase to $7 trillion by the year 2028 when Social Security will begin redeeming its bonds to add to its dedicated revenues so that it can pay benefits in full. I don't consider a $5 trillion nest egg or a $7 trillion nest egg insolvency yet.

The other night the President in the State of the Union said somehow in the year 2028 the Government of the United States is going to have to come up with $200 billion to give to Social Security. Well, I surely hope that the U.S. Government can come up with $200 billion to give to Social Security when it is sitting on a nest egg at that point in time of $7 trillion in Treasury bonds.

Now, there are detractors of Social Security who say that these trust funds are fiction, and that the Treasury bonds they hold are just scraps of paper, IOUs. I hope, Mr. Secretary, that you will set this record straight today, that you will assure us and bondholders around the world that the U.S. Treasury will uphold the full faith and credit of the United States and meet its obligations as they come due, and that these bonds are just as strong as the economy and the full faith and credit of our Government.

To wrap up, Mr. Chairman, Mr. Secretary, if we on this side don't agree with the solution that you are advancing, it is partly because the logic of it escapes us. First of all, this problem is brought on because the Social Security Trust Fund may not have sufficient assets to meet its obligations in full through 2042 if you listen to the actuaries at Social Security, or through 2052 if you listen to CBO. The actuaries give us the present value of the shortfall at $3.7 trillion. Your solution is not to add to that shortfall to try to make it sufficient, but to subtract from it by allowing payroll taxes to be diverted into private accounts, which makes the problem worse; the shortfall greater, not better.

Second, private accounts may or may not be a good idea, but they do little to make Social Security solvent over the next 75 years. You achieve solvency by reindexing the primary insurance amount which over 50 years will slash the budget, slash Social Security benefits in half.

Third, the critical dates that the administration keeps referring to, 2018, 2028 and 2042, will all be advanced by many years if the diversion of payroll taxes is allowed, particularly at the level of 4 percentage points off FICA. Social Security may then go negative, cash negative, as early as 2012 instead of 2018, and the trust fund may be exhausted as early as 2031 rather than 2042. To pay benefits in full, Social Security under the proposal you are making will have to begin borrowing in the 2020s and borrow in the trillions until the midpoint of the century. As the Secretary of Treasury, we would like you to explain to us how the U.S. Government can stack debt on top of debt in these amounts.

Now, we all agree that Social Security is faced with a challenge, that the sooner we resolve it the easier it will be. But we simply can't see the merit in the solution that requires us to borrow $5.9 trillion over the first 20 years and trillions more thereafter, or in a solution that cuts benefits for new retirees in half over 50 years. And we can't buy the notion that this is the only solution we have to choose from.

In 1983, I was here, the retirement trust fund was in dire, dire condition, in danger of running dry in July 1983. Mr. Reagan appointed, with congressional consent, a bipartisan commission headed by Mr. Greenspan. It recommended a number of changes that have assured the solvency of Social Security for 60 years, from 1983 to 2042. This model was shown to work then, and there are

still today menus, whole menus of ideas to choose from if we chose that model again.

So I say to you, Mr. Secretary, why not tune up the model we have got, the Social Security system that has served America so well for more than 50 years, as opposed to trading it in for a vehicle that has never been around the track and never been proven to work.

We look forward to your testimony and to the questions that we will put to your afterwards. Thank you again for coming.

Chairman NUSSLE. Mr. Secretary, welcome to the committee. We are pleased to receive your testimony at this time, and your prepared remarks will be made a part of the record as well. Welcome.

STATEMENT OF JOHN W. SNOW, SECRETARY, U.S. DEPARTMENT OF THE TREASURY

Secretary SNOW. Thank you very much, Mr. Chairman. Mr. Spratt, thank you. I greatly appreciate the chance to appear before you again. I always look forward to this opportunity, always a good exchange of views and the lively discussion that ensues.

Let me say that in the intervening years since I appeared before you last, we have made an awful lot of progress with the American economy. I know how pleased you must be, as we are in the administration, with the fact the American economy is now on a really good strong course. It is a tribute to the Congress, the leadership the Congress provided in enacting the President's tax cuts, because at the very center of the strong recovery that the American economy is enjoying today are those tax cuts.

And it is interesting to go back and look at the growth rates in the economy and job creation in the economy before those tax cuts took effect and what happened immediately thereafter. It was almost like a light switch went on in the American economy. As businesses began to take advantage of the expensing provisions that you made available, the greatly expanded expensing provisions, as the accelerated tax credits took effect, as the lower marginal tax rates took effect, as the dividends and capital gains reductions took effect, equity markets expanded, capital spending picked up, jobs picked up, and GDP picked up. And, Mr. Chairman, you know these numbers, but last year we had a 4.4 percent growth rate in GDP. We have had the best—for the last 18 months since the legislation took effect, the best growth rates in GDP in about 20 years; 2.7 million jobs. And yet inflation stays low because productivity is high.

The housing market is strong, the best we have ever seen. More home ownership in America today than any time in our history. National wealth, household wealth, the highest ever.

I cite this to you to suggest we are on the right course, and we are going to continue on that course. And the budget that is before you is designed to assure that we do that.

That is why the President has asked to make the tax cuts permanent. I think the results of the jobs and growth bill demonstrate the importance of a low-tax environment for the success of the American economy.

I contrast our economy with Europe. Our economy has much lower tax rates, we have much higher growth rates, we have much

higher employment rates. And we are creating lots of private sector jobs while the Euro zone isn't.

But we also recognize that we need to focus on the deficit. This budget tries to do that. It sustains the path that the President called for to cut the deficit in half over the course of the next few years, by the time he leaves office, to bring it to a level—and this is important—to bring it to a level which is low by historical standards. Forty-year average is something like 2.3 percent of GDP. The President's budget carried out over the window, the budget window period, would bring that deficit down well below 2 percent.

There are two keys to bringing the deficit down, and you know what they are. One is to continue the growth of the American economy; because if the American economy stays on a good growth path, not surprisingly, businesses become more profitable, more small businesses are established, entrepreneurship is rewarded, jobs are created, and we have businesses paying more taxes and we have individuals paying more taxes, and thus Government receipts rise. And we have seen that. And the budget lays out a path of increasing Government revenues as the economy gets stronger and stays on the growth path with—and this is a very important point—with revenues as a percent of GDP rising back up to their historic level of about 18 percent.

That suggests to me that our problem with the deficit isn't that we are undertaxed. Quite the contrary, it seems to me to suggest quite plainly that the problem is that we spend too much.

And that brings me to the second part of the equation. The first part is growth; the second part is spending restraint. And you can argue with the particulars of the budget that we have sent up, but the key message from the budget is spending restraint is awfully important to keep us on a path of fiscal responsibility.

But the President is not simply focused on the 5-year window, important as that is. I think we are in good shape on that. He is also focused on the longer term, where I think Budget Director Josh Bolten yesterday talked to you about the long-term problems growing out of Medicare and Medicaid and Social Security, and the need to deal with these unfunded obligations.

That is one reason the President has put Social Security forward as a major national issue. It is why he made it the focal point of his State of the Union message. Social Security is a great part of the fabric of America. It is important that we sustain it, it is important that we secure it, it is important that we make the benefits of Social Security available to future generations, to the young of America.

And yet we all recognize, I think, that there are real problems there. Mr. Spratt acknowledged there were problems. It is hard not to acknowledge the problems. It is not what we are saying, it is what the actuary, the nonpartisan actuary of the Social Security Administration is saying. It is what CBO is saying, it is what the Government Accountability Office (GAO) is saying. And I am glad you will be hearing from them later in the day.

All the people who really know the numbers come to the same conclusion: The system is in real trouble, real trouble. And in 2018, the outflow exceeds the inflow. That is not a good sign. There is a trust fund with a surplus in it, that, Mr. Spratt, we will honor

the bonds in the trust fund. Of course we will. They carry the full faith and credit of the United States. As with all obligations of the United States, they will be honored. But the bonds run out in 2042. And in 2042, with no surplus left in the fund, the fund must fall back on its own revenues, and its own revenues are only sufficient to meet about 72 percent of its obligations. So if we wait until 2042, we are going to shortchange the future retirees.

We can do better than that. That is why the President has put this issue on the table. We can do better than that. And the personal accounts provide younger people an opportunity to build a retirement, to build a nest egg for retirement, to take advantage of what Albert Einstein called the most powerful force in the universe, Congressmen, the power of compounding. And a young person of 24 who retires now has 40 years-plus of compounding of market returns to build a nest egg for their retirement. With that, they will do better than they would under the Social Security system that can't fulfill its promises.

So I think, while you may not agree with the solutions that have been put forward, at least I think we need to acknowledge that the President has provided real leadership here in taking the issue of Social Security to the American people, of focusing on our children's retirement security. He could have passed this one up. He could have passed it on to another President, he could have passed it on to another Congress. He decided that the responsible thing to do was to confront it and to address it.

In confronting it and addressing it, though, he said to seniors, we are not going to affect your benefits. If you are 55 or older, your benefits are absolutely secure. They won't be affected. He said to younger people, we need to work now to put in place savings vehicles for you so your retirement security can be better.

And I think he has performed an extraordinarily important national service by calling attention to the problem.

People object to the term bankruptcy, that Social Security is going bankrupt. Bankruptcy is in fact the condition—impending bankruptcy is in fact the condition that Social Security faces in the very same sense that a private sector company—and my career has been in the private sector—that a private sector company that can't meet its obligations goes into Chapter 11 or Chapter 7 and restructures. In that sense, Social Security is heading for bankruptcy. We don't have to let it happen. By acting now, we can avoid those consequences, we can avoid a huge future burden on the young, and we can give them a much better retirement security.

For all those reasons, Mr. Chairman, I thank you for the chance to be here and talk about this critically important issue. Thank you very much.

Chairman NUSSLE. Thank you, Mr. Secretary.

[The prepared statement of Secretary Snow follows:]

PREPARED STATEMENT OF HON. JOHN W. SNOW, SECRETARY, U.S. DEPARTMENT OF THE TREASURY

Good afternoon and thank you Chairman Nussle and Ranking Member Spratt for having me here today to discuss the President's budget. I think you'll find that it exhibits a dedication to fiscal discipline, transparency, and economic growth.

By focusing on priorities and looking for savings in every agency, across the board, the President's administration has come up with a budget that we believe

is fair while also holding the Government accountable. As the President announced in his State of the Union Address last week, this budget adheres to the principle of "Taxpayer dollars must be spent wisely, or not at all."

It holds the growth of discretionary spending to just 2.1 percent, below the expected rate of inflation. Non-discretionary spending in this budget falls by nearly 1 percent, the tightest such restraint proposed since the Reagan administration.

This administration appreciates that cutting taxes and exercising fiscal discipline must go hand in hand. We appreciate that this is the people's money with which we are dealing, and that we work for the taxpayers.

That is why we are committed to making the President's pro-growth tax cuts permanent and building on our strengthened economic fundamentals as we submit to you a budget that will increase the efficacy of our Government programs without over-spending the taxpayers' money.

Over the weekend, the finance ministers of the G7 met—the U.S. was represented by Treasury Undersecretary for International Affairs John Taylor—and they discussed the importance of promoting and achieving economic growth in our countries, as well as keeping our respective financial houses in order. These two issues are inextricably linked.

The way that we, as the executives of the Federal Government, manage the taxpayers' money sends a message to the people of America as well as to our trading partners and investors around the globe. When we control our spending, we are showing our citizens and the world that fiscal discipline is a priority on par with our policies that promote economic growth.

I'll talk more about fiscal discipline in a moment, but I'd like to start with a look at what we have recently achieved through pro-growth economic policies.

Well-timed tax cuts, combined with sound monetary policy set by the Federal Reserve Board, have resulted in very good economic growth and, most importantly, continual job creation. The economy has created over 2.7 million jobs since May of 2003. And while job growth can never be fast enough for those looking for work, the steady pace of job creation has been an unmistakable sign of an economy that has recovered from very tough times, and is now expanding.

Whenever I speak with my counterparts in the G7, I am reminded that the American economy is the envy of the world. Our recovery and growth, our successful dedication to entrepreneurship—all these things are admired, and increasingly emulated, by our G7 partners.

Is it any wonder that they want to learn the secret to our economic resiliency? A quick look at the facts reveals much to be envied: GDP growth for 2004 was 4.4 percent. Our economy has posted steady job gains for twenty straight months. The unemployment rate is down to 5.2 percent—lower than the average rate of the 1970s, 1980s and 1990s. Real after-tax income is up by over eleven percent since the end of 2000 and household wealth is at an all-time high. Inflation, interest rates, and mortgage rates remain at low levels. Homeownership rates are at record highs.

Tax cuts can be hard on budgets and deficits in the short term, but if the tax cuts are geared toward improving incentives there are long-term benefits as well as short-term ones, and this fact has been well illustrated by these outstanding economic results.

I point to this record because it is so important that we continue on a pro-growth path. Continued economic growth is needed, and will be needed, to continue to improve our standard of living and until every worker in America who is still looking for a job can find one.

For example, we've got to make the President's growth-enhancing tax cuts permanent—and that is included in this budget. The President's Panel on Tax Reform was also created with economic growth in mind. It is a group of some of the best minds in our country, and they'll be looking critically at the entire existing code and coming up with proposals that would make it fairer, less complex, and more pro-growth.

While the Panel is working on that historic task, our efforts to grow the American economy will continue in many other areas—I am particularly interested in legislation that will reduce the burden of frivolous lawsuits on our economy—and this budget is part of the administration's overall pro-growth policy agenda.

As I already mentioned, economic growth is good for our country for the jobs it creates and the prosperity it spreads. But it is also, importantly, part of a winning strategy on deficit reduction—one of the top priorities of this budget—because economic growth increases Treasury receipts.

Treasury receipts are rising—in the second half of calendar 2004, individual income tax revenue is up 10.5 percent versus the same period in 2003—and will continue to rise, as long as we have economic growth. That must be accompanied, as I emphasized earlier, by strict fiscal discipline. That is why the President's budget

proposes real savings. I know it will have its critics as a result, but its frugality is essential.

Let me be very clear on this: we have deficits and they are unwelcome. But we are not under-taxed and higher taxes will not be the solution to reducing deficits. Fiscal discipline, combined with economic growth, is the correct path.

Using this approach, we are making headway on deficit reduction, and we're on track to halve the deficit by 2009. The deficit is also forecast to fall to 3.0 percent of GDP in 2006 and to 1.5 percent by 2009, well below the 40-year historical average of 2.3 percent of GDP.

The 2004 deficit came in at 3.6 percent of GDP—nearly a full percentage point lower than had been projected. And the 2005 deficit is projected to show another decline.

While we are pleased with this progress, we recognize that more needs to be done.

We need to make the tough choices on spending and stand steadfast in our commitment to continuing economic growth in order to see that deficit whittled down.

We also need to look at our long-term deficit situation. I spoke earlier about transparency, specifically the honesty of this budget, which deals openly with the needs of the times in which we live, from the war on terror to the need for continuing growth.

In the interest of honesty and transparency, I encourage all of us to follow the politically courageous leadership of our President by looking at, and dealing with, the $10.4 trillion deficit facing our children and grandchildren in the form of an unsustainable Social Security program.

The program is an important institution, a sacred trust, and it worked well for the times in which it was designed. It is, however, doomed by our country's demographics and in need of wise and effective reform.

The arithmetic is simple. As people live longer and have had fewer children, the ratio of workers paying into the system and retirees taking benefits out has dwindled dramatically. We had 16 workers paying into a system for every one beneficiary in 1950, and today we have just three workers for every beneficiary. That ratio will drop to two-to-one by the time today's young workers retire.

We all must agree that this demographic reality exists, that this problem exists. Social Security is secure for today's retirees and for those nearing retirement, it will not change for those people who are 55 and over... but it is offering empty promises to future generations. When today's young workers begin to retire in 2042, the system will be exhausted and bankrupt.

It is the future of the program that President Bush is concerned about, and it is the future of the program that we must address, this year, here on Capitol Hill. I echo the President's State of the Union Address in saying that we must join together to strengthen and save Social Security.

We can, and should, do this without increasing payroll taxes. The level of increases that would be necessary, if we maintain the status quo, would have a terrible impact on our economy. It would negatively impact economic growth; jobs would be lost. We don't have to go that way.

We can, and should, reform the system in a way that encourages younger generations of workers to build a nest egg that they own and control and can pass on to their loved ones.

Saving Social Security is an undertaking of historic proportions. We have hard work ahead of us as we strive for consensus in the name of younger generations.

We also have hard work ahead of us when it comes to strengthening the fundamentals of our economy: deficit reduction, good fiscal policy, energy policy, lawsuit abuse reform, and encouraging savings.

I appreciate that this administration has an ambitious agenda... but it is a good one, worth the work it will take to move forward, together, on it.

Let's start by passing this responsible, pro-growth budget.

Thank you for having me here today; I'm pleased to take your questions now.

Chairman NUSSLE. Let me start, if I might, by going back to what my friend Mr. Spratt opened with, and that is with regard to the deficit, because we are here to talk about the budget as well. I have just got to say this again. As many times as my friend—and he is my friend and he will continue to say it, and he is technically correct—that on September 11 and thereafter we started running deficits. It didn't just happen, on September 10 we were running a surplus, and on September 11 and 12 and on and on and on, yeah, we started running deficits. But they didn't just happen.

We made deliberate decisions about strengthening the economy, about dealing with the emergency, about strengthening our homeland security, about improving our intelligence, about prosecuting a war on global terrorism. Those decisions, many of which were bipartisan decisions, were deliberate.

So, yes, we find ourselves in a deficit; yes, we are going to run a tight budget, Mr. Secretary, the way we did last year, and we are going to hopefully get results that we saw last year.

As we all remember, and you came in and reported to us—and let me just show you a chart. You reported to us last year that we were going to run a $521 billion deficit, well, we didn't. When we closed the books, it was $412 billion. In 1 year we were able to reduce the deficit by $109 billion. I know my friends will tell me, don't get too pumped up about that because you didn't do it all by yourself, and I know that. Our constituents did it—it is called the economy.

Our economy is a beautiful thing. When it gets unleashed and it starts growing, it can do miraculous things like it did last year. With tight spending restraint—we can be tighter. But with tight spending restraint and with a growing economy we can begin to reduce some of the challenges that we have such as the deficit. But the challenges of the war, the challenges of international relations that we have out there, the challenges of intelligence, of homeland security, they are still there. We want the economy to keep growing, so we don't want a tax increase right now.

So we are going to keep the economy growing, and you can report back to the President that his budget is alive and well on Capitol Hill.

Having had the opportunity to meet with the budget director yesterday and talking to my colleagues and our leadership and members, we believe that we can get it done. Now, it is going to be tough, because all of that spending, as you well know, got there for a reason, and each and every one of us can identify something that we voted for and some important challenge for our State, district, or country that we believe in. So it all got there for a reason. You have our commitment that we are willing to work with the President in order to reduce this deficit and continue to meet our challenges. But a growing economy is an important part of this factor.

Now, turning to the subject that we have today. So, if our economy is growing and growing so well, let us just grow out of this problem. I mean, come on, Mr. Secretary, our economy is a beautiful thing. Let us just grow out of the problem of Social Security, I have heard people suggest that.

The interesting thing about it is, I heard the same thing back in the 1980s and 1990s when Republicans said let us just grow out of something, and, boy, we were lambasted for saying we can just grow out of the problem. Now I hear it from my friend on the other side that, just let us grow out of the problem of Social Security.

So I would like you to address the grow-out-of-it opportunity that we have. Can we grow out of the problem that we face with regard to the challenge of Social Security?

Secretary SNOW. Mr. Chairman, thank you. Unfortunately, no, we can't grow our way out of the Social Security problem. With the economy as a whole, growth helps us an awful lot in dealing with

the deficit because we pick up the top line, the revenue line. Unfortunately, the way Social Security is structured, growth translates into higher benefit levels and higher payout levels. So growth in and of itself has very little effect because of the benefit formula in Social Security, in improving the solvency of Social Security. I wish it were otherwise, but the fact that the benefits are indexed to wages and wages reflect productivity and growth in the economy makes growth in and of itself not—not—very helpful in solving the sustainability issues of Social Security. It will help, I must say, it will help a lot in dealing with the larger Federal deficit, but it won't Social Security as such.

Chairman NUSSLE. Well, I have also heard that there are those who suggest that the Government—the Government, you know, at the appropriate time, I assume they mean the Federal Government at the appropriate time, and I assume that means 2018 or 2019 or whenever we start running into this challenge, that we should just replenish the account, we should just replenish the trust fund, we should just start paying the benefits. You know, just put the money in there. Why is that, in your opinion, something that might or might not work?

Secretary SNOW. Mr. Chairman, the notion of replenishing the trust fund sounds appealing on the face of it, but how would it be replenished? It would be replenished by tax increases in the most likely case. The tax increases that would be required to put Social Security on a sustainable basis would roughly double the current taxes, 50 percent increase in the current tax rate. And I would hate to see us go down that path because a 50 percent increase in Social Security taxes, which is required to put the system on a sustainable basis, would almost surely wreck the American economy. It would almost surely lead to very high unemployment rates, very slow growth rates, perhaps a recession.

And I look at Europe and the Euro zone and their tax rates on labor versus ours, and you see the consequences, you see them visibly right before your eyes. Their growth rates are about half of ours, their unemployment rates are twice as ours. They aren't creating anywhere near the number of private sector jobs we are. We don't want to go that way, in my view.

The other way is to cut other programs. That is a tough course to follow. And the third way is to borrow. And you will say, but you are borrowing; and I will say, yes, we are. But there is a big difference in the sort of borrowing we are proposing to fund the personal accounts and the sort of borrowing that would be required simply to put money into the trust fund.

Chairman NUSSLE. What is that difference?

Secretary SNOW. Well, the big difference is that by doing it the way the President has proposed with his personal accounts, we are borrowing to save. Every dollar borrowed becomes a dollar saved, as opposed to every dollar borrowed becoming a dollar spent. That has far different effects on the national accounts of the United States and on the economy of the United States. The President's proposal will translate borrowing into savings.

Chairman NUSSLE. Well, give me an example. I am borrowing $100, all right? Let us keep it real simple so I can explain it to my son who, according to the charts, isn't going to have Social Secu-

rity. So I want to be ale to explain this to my 14-year-old son. All right? So I have got $100 that I want to borrow. Now, what is the difference between borrowing that to save and borrowing it to spend? I mean, isn't it still borrowing $100?

Secretary SNOW. It is borrowing $100 in both cases. But in the case of your son and his personal account, the money, the $100, becomes part of the capital stock of the United States; it becomes part of the savings of the United States; it becomes capital used to strengthen the growth of the American economy. The spending—and it may well be for a very good purpose—but the spending is spent and it is gone. The savings becomes part of the capital base of the United States.

Chairman NUSSLE. Does it grow?

Secretary SNOW. And with time certainly it would grow. One of the beauties of the personal accounts is the opportunity to use this power of compounding, which, according to virtually all financial analysts, if you get a mutual fund-type investment with 60 percent equities and 40 percent bonds, put the $100 away, over a 40-year period that $100 is going to be worth a huge multiple of the $100. So the $100 becomes many times the $100 available then to your son when he retires. The difference is it is savings rather than spending. Spending disappears; savings builds and grows.

Chairman NUSSLE. And then I have got to understand why this is so urgent. I mean, you know, 2018, most politicians only worry about the next election around here. Some think a little bit further than that, but by and large we are not used to thinking more than about the next election. You have to pardon us a little bit. You know, 2018 is a lot of election from now for most people. So why is it so urgent? I mean, can't we just wait until—how about let us try 2016? Why does the problem get so much worse between now and 2016 that we can't just wait and deal with it then?

Secretary SNOW. Well, again, Mr. Chairman, citing the actuary of the Social Security system, every year we put this off, every year we postpone action, the problem becomes bigger and bigger and bigger and bigger. As I recall the actuary's, assessment, the problem rises at the rate of about $600 billion a year. And whereas today, if the problem were solved simply by reducing benefits or simply by the shortfall or solved simply by raising taxes, you could do so with a 3.2 or 3.3 percent reduction—or increase. If you wait, you are going to have to have a 6.5 percent, 7 percent-type increase. So by acting now, by acting now we have the ability to put in place solutions that are far less costly. And we also by acting now have the opportunity to put in place these accounts which will use the power of compounding, take that $100 and make it many times the $100 the future when younger people like your son move to retire.

We also by acting now I think show good faith with markets. Markets are watching us. Markets ultimately render judgments on people in positions of political leadership. I think the markets are giving us credit. They are saying, yes, you are going to address this problem. The issue is important because that $10.4 trillion obligation is out there and it hangs over the markets. By showing responsible behavior in defeasing it, in removing it, we are keeping faith with the financial markets of the United States and the finan-

cial markets of the world. And that sustains low interest rates. And low interest rates are one of the principal things we have going for us in sustaining a strong economy.

So for all those reasons, Mr. Chairman, I would suggest that we really have no option but to act now. The problem is urgent, and the sooner we act the better. And the longer we wait, the bigger the problem becomes and the harsher the solutions.

Chairman NUSSLE. Thank you, Mr. Secretary.

Mr. Spratt.

Mr. SPRATT. Thank you very much, Mr. Chairman.

Mr. Secretary, we are trying hard to understand this proposal in full. This is a Budget Committee, and our understanding of it thus far is it will have an enormous impact on the budget for years to come. In fact, if the borrowings to finance transition are of the magnitude we expect, I don't think we will see a balanced budget again in our lifetimes.

You know enough apparently to give us a number, $754 billion, as the cost during the first 10 years, assuming implementation of your proposals in around 2009 to 2011. Can you tell us what you expect the cost to be in the first 10 years after full implementation and in the second 10-year period thereafter?

Secretary SNOW. Mr. Spratt, I can't because——

Mr. SPRATT. Can you give us an approximation?

Secretary SNOW [continuing]. I don't yet have a detailed understanding of what will come out of this legislative process.

Mr. SPRATT. I am asking what you are proposing, not for what we produce.

Secretary SNOW. Well, until we know the details, though, of the proposals that will come from the negotiations with Congress, the process that has now been launched, it is very hard to quantify what those future costs would be. But, I mean I certainly would grant you that the borrowing wouldn't cease at the end of the 10-year period; it would have to go on. And, but I have not run any or seen any runs of an—actuarial runs of what the next 10 years and the 10 years after that would be, because I think it depends so much on the details. But we have to acknowledge that it is going to be a continuing budget item going forward.

Mr. SPRATT. Well, if you haven't seen the details as Secretary of Treasury, how can you pass judgment on them?

Secretary SNOW. We have seen the details and we have made available the details of the proposal for the first 10 years. But what happens with the cap, what happens with the contribution levels and so on, and what happens with the other aspects of the Social Security proposals is something that isn't knowable at this point.

The President has put forward four or five options for dealing, in addition to the personal accounts, for dealing with the problem. He has invited Members of Congress to join him in thinking about the problem and coming up with other ideas. He doesn't think we have got all the good ideas.

Mr. SPRATT. But you are his point man. The reason we are putting the question to you is you are the chief numbers operator in the Bush administration, and we are trying to get some financial explanation of what the impact of this proposal will be on our budget. And we are finding it a very elusive pursuit. We aren't

even able to find out what the cost is going to be over the first 20 years, although we know it is going to be significant. By our calculation, it is going to be close to $5 trillion in additional debt of the United States. Does that comport with your back-of-the-envelope analysis?

Secretary SNOW. Well, Mr. Spratt, as I say, I don't have the runs on that, the actuarial runs on that, so I can't confirm that. It sounds a little high to me. But certainly there would be continuing borrowing requirements and interest payments requirements. But remember, net-net we are simply making explicit an obligation which is implicit, and by doing that we are not adding to the long-term costs of the U.S. Government.

Mr. SPRATT. Well, first of all, we are accumulating debt in the regular budget at a rapid clip. I showed you the numbers, $2.234 trillion increase in the debt ceiling to accommodate the Bush budget for the first 4 years, $2.2 trillion. And we are running at that rate now, about $1 trillion in debt accumulation every 18 months. By 2012, 2015, we are likely to have $12 trillion in statutory debts subject to limit. If you go ahead and take then that debt, which is increasing as we speak, and add on top of it another $5 trillion, the Treasury is going to be in the private capital markets frequently borrowing big sums of money repeatedly and crowding out private borrowers, is it not?

Secretary SNOW. No, I don't think so. I don't think so at all in this case because, again, this borrowing is not borrowing to spend, this is borrowing to save. And it is borrowing to defease a very sizeable long-term obligation.

Mr. SPRATT. But it is still borrowing, and the Treasury of the United States has to go in the capital markets and say I want $1.5 trillion dollars for these Treasury bonds.

Secretary SNOW. But Mr. Chairman—I mean, Mr. Spratt.

Mr. SPRATT. I will take that.

Secretary SNOW. Mr. Spratt, there is a real difference here, and it is important to maybe take a minute and talk about this, because this isn't your traditional debt. It doesn't have the effects of traditional debt on markets. I have spent a lot of time now talking with the analysts in the Treasury Department who make the U.S. Treasury market, the people who are responsible for the largest debt market in the world, the U.S. treasuries. I spent a lot of time talking to people up on Wall Street about this. And Wall Street, I think, financial market people, people who worry about the bond market and credit ratings, they are going to applaud us, they are going to applaud you and the Congress for taking this issue on and defeasing that $10.4 trillion long-term liability. And they would readily find, I am convinced, the funding manageable.

Mr. SPRATT. There is still going to be debt of the United States, and there will be interest payments either quarterly or semiannually. Those payments will have to be made. We will have a huge and growing amount of debt service, and that debt service is going to displace priorities in our budget, is it not? It is going to be a mountainous amount of debt service if you have $5, $6, $7 trillion dollars of additional debt. It has to be serviced. Does it not?

Secretary SNOW. Well, certainly all debt has to be serviced. But, remember, when we do the borrowing it is of an equivalent value

to the reduction that is occurring in the liability in the Social Security system, because the borrowing, the borrowing is exactly equal to the amount of money that is being taken out of the system and put into the personal accounts. So, in effect, it is a wash. The Social Security liabilities are coming down by an amount that is equal to the borrowing.

Mr. SPRATT. But the interest is a net payment of the U.S. Government. We will have to shell out the interest in increasing amounts, and it will displace other priorities in our budget.

Secretary SNOW. Well, not necessarily. No, that is not the way to look at this. If the borrowing doesn't affect——

Mr. SPRATT. So we can borrow money with impunity then.

Secretary SNOW. Well, no, you don't, because you don't borrow if you spend. You can borrow to save; you can't borrow to spend. And that is the key difference. This is borrowing to save. And if you look at this I think in the right way, the savings of the United States are going to rise, not fall. At least they won't be negatively impacted. If the savings of the United States aren't negatively impacted, then——

Mr. SPRATT. You are diverting money from the public trust fund into private accounts. At best, it is a wash. Instead of going into the public trust fund where it would be saved, it is going into private accounts where it is saved. So at best it is a wash.

Secretary SNOW. I would look at it a little differently. I would look at it this way. That is going from a pay-as-you-go system to, in a way, Mr. Spratt, the very lockbox you talked about, because the money is now going into a private account that could be analogized to a lockbox. It is in there, it can't get out. The Government can't take it away from you. They can't go spend it. It is in the lockbox. It is not called a lockbox, it is called a personal account, but it has the same effect.

Mr. SPRATT. Let me ask you to wrap up on this line of questioning. When can we expect the numbers? When can we expect to see a full financial display of how much debt we will have to incur to sustain this proposal?

Secretary SNOW. I wish I could give you an answer in terms of a specific time. The time will be as the details of the proposal get worked out with you and Members of the Congress, is the best answer I can give you, the most honest answer.

Mr. SPRATT. Let me ask you then another question about a different line. I have looked at model 2. And, as I take it, you are working off model 2 of the President's Social Security Commission. And model 2 clearly acknowledges, particularly if you read the actuary's letter that explains it, that the private accounts don't account for the achievement of solvency within 85 years. That has to be done through benefit reductions or revenue enhancements, one or the other. And, in particular, model 2 actuary's letter indicates that the primary source of solvency is achieved by reindexing the basic primary insurance amount. They go on to acknowledge, if you read it closely, that the replacement ratio, if this is done, over 50 years will be cut in half. That is a substantial reduction in benefits. And that is a means by which you achieve solvency. It doesn't have a thing to do with private accounts. Am I correct?

Secretary SNOW. I would have to go back and review model 2. I get model 2 and model 3 and model 1 sort of muddled sometimes. But I think essentially you are right; model 2 doesn't rely on the personal accounts alone to fix the system. But I think model 2, and model 3, as I recall, have the personal accounts as an integral part of the solution.

Mr. SPRATT. The actuary indicated for that study that the cost of fixing Social Security would be equal to 1.89 percent of payroll. In other words, that was the shortfall expressed as a percent of payroll. The actuary's letter said that the manner in which the primary amount of insurance would be determined indexed to prices instead of wages would account for 2.07 percent of payroll.

So that was virtually the whole of the solution right there, in the reindexation solution of the bend points, redetermination of the primary insurance amount and over time, prospectively, it becomes a significant reduction in benefits.

Secretary SNOW. Yes, I think Plan 2 does, by indexing to prices rather than wages, have the effect long-term of reducing at least the growth rate—I think, is maybe a better way to put it—the growth rate of benefit levels. But even then, I think it has the retirees, the beneficiaries, having replacement rates which are better than their parents and grandparents.

Mr. SPRATT. Oh, no, not if we assume that the collateral account earns the bond rate of return, you will see a reduction in the—you will see a reduction in the replacement ratio of preretirement income for the median beneficiary retiring at age 65 earning the median income of over 50 years, the replacement ratio will decline from 43 percent to 22 percent. They will get half what their grandparents got.

Secretary SNOW. The replacement ratio declines, but the actual——

Mr. SPRATT. Well, sure wages go up, no question about it.

Secretary SNOW. But the actual payout is higher than their parents or grandparents in real terms, and I think with the private—the personal accounts, with the personal accounts, the payout is higher than what would be available from Social Security alone, given the fact that Social Security can only pay out a fraction of the promised benefits.

Mr. SPRATT. Well, if you go back and read model 2, I would recommend it to your attention.

Secretary SNOW. OK, I will do that.

Mr. SPRATT. You will find that they cut the replacement ratio in half over that period of time, and that makes this system not a fundamental source of retirement benefits but almost an incidental. It changes the character of Social Security.

Let me ask you—and I will then let others have a shot. If we assume that these—and everybody is subject to this change in the indexation of the primary insurance amount, everybody, whether they opt into private accounts or not; everybody gets their benefits recomputed according to this different model.

Now, that raises a particular problem for one-third, 30 percent, of the beneficiaries who are disabled beneficiaries or survivorship beneficiaries. They will have the same benefit reduction that others will have out through time, but in addition to that, they will not

have the opportunity, because they will be drawing that benefit sooner than age 62 or age 65, they will not have the benefit of allowing the collateral accounts to build up. What happens to their benefits? It is critically important to the disabled and the survivor.

Secretary SNOW. You put your finger on a very, very good issue, and the President in his principles to deal with Social Security has focused on that and said that nothing should be done to diminish the well-being, the welfare of the disabled, as a result of any of the fixes.

Mr. SPRATT. So what do we do? What is the solution? The problem is inherent in the proposal as a problem, I understand that.

Secretary SNOW. I agree with that. It is in Model 2, it is inherent so you would have to take that fix into account, whether you—and there are various ways you could do that—but including not applying the index to the disabled or making a commitment that the disabled would receive payment——

Mr. SPRATT. Then you would have disabled beneficiaries receiving a return higher than comparable age beneficiaries would receive at retirement who worked a whole 35, 40 years.

Secretary SNOW. Now, you are putting your finger on the very reason the President said we want to work with Congress to find the answers.

Mr. SPRATT. Well, now you are passing the buck.

Secretary SNOW. Well, no, I am not.

Mr. SPRATT. I am asking you for what your proposal——

Secretary SNOW. I am saying this is an issue on which I think the administration and Congress should, should spend a lot of time focusing.

Mr. SPRATT. Well, what you are giving me as a fairly inchoate picture of what has been developed at this point in time. We have still got a very, very great number of items of fundamental vital importance that have to be defined before anybody can pass judgment on the validity of the attractiveness of this system.

Secretary SNOW. As the chairman said in his well-put opening comments, we are really trying to make sure we have an agreement on the nature of the problem. If we can have an agreement on the nature of the problem, I think finding the answers will come, will come a lot more readily.

We are prepared to work with you, Mr. Spratt, on the answers. But I think finding the answers depends on having some agreement whether or not the Social Security actuary is right in saying that, in 2018, the outflow exceeds the inflow.

Mr. SPRATT. Well, wait now, the outflow does not exceed the inflow if you pay interest on your bonds. If you are paying interest on your bonds and add that to the inflow, then the inflow exceeds the outflow in 2018.

Secretary SNOW. I am saying the current system, if we could have agreement, that the current system was unaltered, just on its own, the way it is running, will be—produce inflows that are less than outflows in 2018 and will produce in 2042 an inability to pay the benefits then scheduled, that would be the basis for finding, I think, foundation for a discussion to produce some answers. But I am not sure we are there yet.

Mr. SPRATT. Well, I do not think we are there either. I mean, I think we have got a massive amount of detail and information necessary to flesh out this proposal. You would agree, I take it?

Secretary SNOW. I do not. I do not agree that the problem has not been well defined. I think the actuary, I think CBO has been helpful.

Mr. SPRATT. We cannot even agree on the method about which insolvency is to be achieved, about whether or not the reindexation of the primary insurance amount plays in that.

Secretary SNOW. What I think we do agree—all—I think everybody who has looked at this has agreed, everybody who has looked at it in a serious way, from an actuarial point of view, everyone has agreed his system is not on a firm foundation. The system is in trouble. The President has said we have looked at this in the past and we said, let us have a temporary fix.

All we have ever had is temporary fixes, and all we have done is kick the problem down the road to future Congresses and future administrations. He is saying—I think he is to be commended for it—he has said let us get a permanent fix, let us really fix this thing right, let us not kick it down the road. Let us not kick it to another Congress. I think that is commendable.

Mr. SPRATT. Let me go back to words you use, this is not on a firm foundation, I will grant you, we have a problem in 2042. The easier, sooner we agree with it, the better it will be. But as to the foundation, in 2018, Social Security is sitting on $5 trillion to $6 trillion in Treasury bonds; 2028, the amount of nest egg actually increases to $7 trillion. That is a pretty firm foundation for us to stand on while we try to work out a good sensible, fair and operable solution; isn't it?

Secretary SNOW. But the sooner we get to it, the better.

Mr. SPRATT. No question about it.

Secretary SNOW. The sooner we get to it is better for you and I, I think. If we do not get to it, that surplus gets exhausted and funded from some source——

Mr. SPRATT. No question about it. You keep saying 2018, and I keep saying, wait a minute, $5 or $6 trillion in Treasury bonds. That is pretty liquid.

Secretary SNOW. But it has to be financed. It has to be financed, and the—and I think it is by 2040 or so, the whole that has to be financed is on the order of $600 billion.

Mr. SPRATT. One final question.

To me, it is obligations under the proposal that you are formulating. Social Security or the general fund of the Treasury will have to borrow substantial sums after 2020 to make up for the deficiency in the trust fund which is aggravated by the fact that you are going to be diverting a third of the revenues away from it.

How far and how much from that point onward do you have to borrow? When do you cease having to borrow money? Is it 2062?

Secretary SNOW. Yes. I wish—I do not want to be evasive or sound evasive. It depends on what the fixes are we come up with. There are fixes that would have it in that timeframe. There are fixes that would have it sooner. There are fixes that would have it later. It really depends on what the ultimate solution is.

Secretary SNOW. Give us an approximation, the average and likely proposal you are going to make. Is it around 2062 you will be borrowing money to supplant, replace the benefits of Social Security? Some timeframe like that, you know, depending on—take 10, 15 years, either side of it, depending on what the form of the ultimate—the resolution is. But I will grant you that.

Mr. SPRATT. Thank you, sir, I appreciate your answers.

Chairman NUSSLE. Mr. Portman.

Mr. PORTMAN. Thank you, Mr. Chairman.

Mr. Secretary, I thank you for being with us today and getting into some of the details of Social Security. This is the Budget Committee, so I will start by commending you on your budget which does restrain spending and does promote economic growth while funding our key priorities, and we know that is the magic. We did it back in the late 1990s, to getting back to fiscal discipline. I think your budget presentation made by Joshua Bolten yesterday does exactly that.

On Social Security, I wish I had more time. But I guess my response to my friend, Mr. Spratt, he knows I respect him, you know, you cannot have it both ways. I think we are totally irresponsible, as Members of Congress, to be telling our constituents that the trust fund will be in a position to fund Social Security without sacrifice.

You know, what the trust fund is, thanks to Congress, you know, over the last 30-plus years, is something that we have borrowed from. And we borrowed from it today, and our deficit numbers reflect that. In other words, there is more than there should be. For us to sit here and say we are concerned about the costs of personal accounts, and there is a transition financing to personal accounts but we are not worried about financing the $5 or $6 trillion trust fund deficit, I think is irresponsible.

I think Members of Congress need to be very careful about this, because it is dangerously misleading to our constituents. I mean the honest truth is, the way the trust fund works, it is sort of like the Government reaches into its wallet, pulls out a little money to spend and that money gets spent on everyday purposes of government, and then we put an IOU in the coffee can, saying I owe myself $5; that is how it has worked. I really think we needed to be very careful about how we talk to our constituents and deal with this issue.

Mr. BAIRD. Would the gentleman yield for one moment?

Mr. PORTMAN. No, I will not, because I do not have enough time.

Mr. Secretary, tell me, between 2018 and 2042, what is the amount of money that the Government would need to have by raising taxes or by borrowing more to be able to redeem the Government bonds in the trust fund, what is that amount of money, just between 2018 and 2042?

Secretary SNOW. I think that is about $2.7, $2.8 trillion.

Mr. PORTMAN. $2.7, $2.8 trillion. Where are we going to come up with it folks? I mean, this is the honest truth. I know it is painful, and it is hard for us to realize, but we have intergovernmental debt, and we have public debt. And they are very different things. Here, intergovernmental debt we have borrowed against. We are borrowing against it this year.

For us to sit here and say, it is there, and it has been there for Social Security, and there is no pain involved in this, it is just wrong. We are going to have to raise taxes. We are going to have to borrow. We are going to have to cut benefits. We are going to have to do something.

On the other hand to say, gee, we cannot do these personal accounts because they cost too much.

Mr. Secretary, you said the $100 invested in personal accounts for 40 years would be a lot more than $100. I am assuming a 5 percent rate of return, which I think is conservative. That is $704; $100 becomes $704; $10,000 becomes $70, $100 becomes $100,000. I mean, $100 becomes $700,000. This is what Einstein talked about, the magic, the greatest force in the universe, the power of compounding interest. That is what we are talking about here.

Yes, it is not cost-free in the interim period, but it actually, it actually helped solve the Social Security problem because of this buildup of assets, and the fact that then Social Security will have less of a responsibility for those people who choose voluntarily to get into the personal accounts.

That is why it is such an exciting proposal and why I strongly support it. Yes, we need to deal with the transition financing, and we will. But we need to do so understanding that the other option of relying on the $5 or $6 or $7 trillion in trust fund is not cost-free either, and we ought not to mislead our constituents about that.

In terms of the funds that would be used for the personal accounts, Mr. Secretary, you indicated that it is different because it is money that would go into savings. I would agree with that. But also it is different—isn't it—because it defrays our long-term liabilities. Can you talk a little about that as well?

Secretary SNOW. Yes, absolutely. Remember what is being done here. According to Social Security actuary, there is a $3.7 trillion hole, obligation, unfunded obligation of the United States over the 75-year horizon, and it is $10.4 over the permanent horizon, rising at about $600 billion a year.

What the proposal does is not only create a better retirement than Social Security can make available for younger people and future generations, but it defeases that obligation. It removes that obligation.

That is why I said earlier, Mr. Portman, that Wall Street looks favorably on this, because they know that we are improving the balance sheet of the United States. We are putting our long-term fiscal house in order.

Mr. PORTMAN. So it is borrowing that goes into savings, and it is borrowing that goes into defraying the liabilities we all know exist in Social Security.

Let me just give you one final fact: That $100 you talked about—assuming a 5 percent rate of return—becomes $704. That is the 24-year-old you talked about. For that same 24-year-old, who will get on average, we are told, who will get a 1.8 percent rate of return under the Social Security, that $100 that person would invest in Social Security would result in a $204 return; $704 versus $204.

Thank you, Mr. Secretary.

Secretary SNOW. Yes. One way of thinking about your younger—about that person and your children—is that they become owners in America, investors in America in exchange for being creditors on a Government promise that cannot be fulfilled.

Chairman NUSSLE. Mr. Moore.

Mr. MOORE. Thank you, Mr. Chairman.

Thank you, Mr. Chairman.

Thank you, Mr. Secretary, for being here today. Mr. Chairman made the statement during his opening remarks that members and politicians do not look beyond the next election. I want to respectfully take issue with that, because I am very, very concerned about my children, about my six grandchildren and their contemporaries out there and how they are going to dig out of this financial hole that we are putting them in right now.

We have a $7.6 trillion national debt in this country. We are paying almost $1 billion a day in interest on our national debt. Deficits are running well over $400 billion a year. I think, respectfully, we need to change the way we are doing business in this country, and this should not—should not—be about Democrats and Republicans. We are all in this together. I do, really do have grave concerns about the future generations in this country if we do not turn things around.

You said, Mr. Secretary, how can the trust funds be replenished and how can we achieve a solvency here?

Yesterday, Mr. Secretary, I filed a bill that is called the—well, it does not matter what it is called—but what it will do is establish a true, a true trust fund. That would save the American people. Money that comes in for Social Security taxes cannot be used for even worthwhile programs such as education, healthcare, tax cuts, Iraq, anything else, but has to be set aside and saved for Social Security purposes in the future. That does not totally solve this problem of solvency of Social Security over the next few years, and I think every member in this room—and I hope probably in the Congress—believes there is a problem, maybe not a crisis, but a problem that needs to be addressed sooner rather than later.

I would hope that we would start to be honest with the American people—and I do not think most people out there understand that the money that does come into the Social Security trust fundright now is used for every other purpose, and it is just not there—and we say, look up here, but do not look at what we are doing with the money down on the other hand.

We need to start, I think, setting aside the money and preserving it for the intention and intended purpose. If we did that, again, we would be several steps in the right direction of extending the life of Social Security into probably several decades into the future.

I want to ask a question though about this. I saw in the paper this morning, The New York Times, about a $720 billion estimated cost by the administration, just came out over, the next 10 years for the Medicare drug program. I do not know if you have seen that, Mr. Secretary, or if you are aware of that announcement.

Secretary SNOW. Not—I saw the headline in The New York Times, but I have not yet had an opportunity to really study the issue, Mr. Congressman.

Mr. MOORE. All right. Well, apparently some administration official offered an estimate of the cost of the Medicare drug benefit Tuesday saying it would cost $720 in the next 20 years. Congress has told us it would cost $24 billion. I do not want to get into all that.

I do want to say this: It does cost a lot of money, a drug benefit through Medicare. What I handed you right before this meeting started was what I proposed—another bill I filed called the Meds Act.

Back in 1992, the Secretary of Veterans Affairs was given the authority under Federal law to negotiate with pharmaceutical companies on behalf of about 25 million veterans for lower pharmaceutical drug prices. We have 44 million Medicare beneficiaries in this country. Each one right now is a one-person buying group. If we were to get a group discount for 44 million Medicare beneficiaries, I would think they would achieve the same kinds of savings hopefully that the veterans would have. The veterans I had talked to are pretty pleased with the benefit they get. I would ask you to go back to the administration and ask them to consider something like this.

This was specifically prohibited in the Medicare bill that Congress passed, and I think it would be a—I would ask you if you have any comments on that, Mr. Secretary.

Secretary SNOW. Congressman, I remember when we were at that nice luncheon in Kansas City when a subject like this came up. You were thinking about it then and yet put it into the form of legislation—let me just say——

Mr. MOORE. Thank you.

Secretary SNOW. I would be delighted to look at it and give you some thoughts on it.

Mr. MOORE. Thank you.

The last issue I want to raise with you, and I am out of time, is this: I was with our European counterparts, NATO allies, in mid-November last year, and they raised the prospects of our $7.6 trillion debt. They talked about the fact that foreign nations, European countries, Japan and even China are financing our debt, a financial portion of our debt.

They said they are concerned about the value of the dollar and what is going to happen in the future.

Should we be concerned about that, Mr. Secretary?

Secretary SNOW. Not if we do the right things, and we are trying to do the right things, and not if other people who have a responsible role to play here do the right things as well. The current account deficit is—again, we have talked about this in Kansas City. The current account deficit is really the difference between the rate of savings in the United States, domestic savings, and domestic investment opportunities.

Right now, with our economy doing so well and growing so fast relative to our trading partners, we are creating a lot more investment opportunities in the United States than we are savings, so we need to borrow from others to finance the good investment opportunities in the United States. It would help if trading partners would grow faster. We are talking to our trading partners about doing that and the things they could do to grow faster. It would be help-

ful if we could save more. That is where the deficit is so important, because if we save more, we eliminate a source of dis-savings.

Alan Greenspan, Chairman Greenspan, gave a speech a few days ago, saying that he thought the current deficit was in the process of turning the corner and cresting and coming back the other way. I think there are some reasons to think that that truly is the case. It would be helpful on that score if China would move to a more flexible exchange rate and go through the process of letting their currency be set more in open competitive markets rather than set by administrative fiat.

Mr. MOORE. Thank you, sir.

Chairman NUSSLE. Mr. Wicker.

Mr. WICKER. Thank you, Mr. Chairman.

Thank you, Mr. Secretary, for your testimony.

Let me follow up on a point that Mr. Portman was making. Right now, say you have got a couple out there in their late 20s, early 30s, got a couple of kids, and they are struggling along trying to pay their bills. Right now, we are taking 6.2 percent of everything they make in FICA taxes.

As I understand it, what we are promising them right now is something that is going to get them somewhere around a 1 percent return when they finally get to retirement age, plus or minus, but it is a very low 1 percent return. Is that right, Mr. Secretary?

Secretary SNOW. It is. It is a very low return.

Mr. WICKER. Let me just observe: If we could do better than that for our hardworking families out there, we ought to do better than that. We ought to take action that gets them a better return if we are going to take that much out of their paycheck.

I was gratified to hear our ranking member acknowledge that there is a problem. I mean, I think that is a start. There is a question about whether it is a crisis or how urgent it is. But at least we are all acknowledging that there is a problem.

Now, in the past, when Congress has decided to address the problem, they have done what I think you referred to, Mr. Secretary, as a temporary fix, kicking the can down the road for a few years.

There are things that we could do again, totally different from what I think the President is going to propose. We could adopt a means test for benefits in the future. In other words, we could take 6.2 percent of people's money—and they get to certain income levels—and say, well, you are not going to get it anyway. We could reduce benefits. Certainly, Congress has, in the past, raised the payroll tax. We could, again, raise the retirement age. Congress did that many years ago. It is just now sort of coming home to roost there. We could increase the earnings limit. Without doing anything else, we could adopt a lower cost-of-living index. All of those things, I think, are not going to be very popular among the American people.

But let me ask you, if we did any of that, would it help that young couple that is 29-years-old or in their early 30s with two kids and paying 6.2 percent of everything they make, would it help them get a better return at the end of the day?

Secretary SNOW. It would, Congressman, that is a good way to frame the issue. It would if the personal retirement accounts are included as part of this as well.

Mr. WICKER. OK. But I am not hearing much support from my friends on the left about the personal retirement accounts. Absent the personal retirement accounts, kicking the can down the road, means testing, reducing benefits long-term, raising taxes, raising the retirement age, raising their earnings limit, that still gives that couple 1 percent at the end of their working life, doesn't it?

Secretary SNOW. I think that is right, and that is why the opportunity the personal retirement account affords people should be part of any solution, because it does give them—I think the math on this is irrefutable. Congressman Portman took you through some of it, but the math on this is irrefutable.

For a young person who has 40 years or 45 years to put away money and who earns the long-term average of a blended bond in equity, they are going to come out way, way, way ahead of that 1 percent.

Mr. WICKER. Right, but let me agree with a very important point the ranking member made. It is going to help when we can get specifics on the administration's proposal, because I certainly appreciate that you cannot answer the very specific questions that members on both sides of the aisle have, until we do get the specifics.

But I do understand that whatever the administration proposes, it is going to be voluntary, is that correct?

Secretary SNOW. Absolutely. In other words, that couple can decide to get into personal savings accounts, or they can stay with their 1 percent for whatever reason.

Also, there is going to be the same guaranteed benefit at the end of the day and whatever the administration proposal is. We are not just going to hang them out there to float.

Secretary SNOW. The whole proposal is voluntary for younger people. Of course, not available to 55 and older who are—all their benefits will be secured.

Mr. WICKER. Yes, I would think you may start getting a few complaints from those 55 years of age and older that they cannot buy into these personal accounts.

But thank you very much for your testimony.

Chairman NUSSLE. Mr. Edwards.

Mr. EDWARDS. Thank you, Mr. Chairman.

Let me just say, what I am observing is that the same people who, I assume, in good faith 4 years ago, 3 years ago, 2 years ago, wrote partisan budgets that turned a $270 billion a year Federal surplus in 3 years to the largest deficits in American history, having broken the promise that they could pass tax cuts and balance the budget, are now promising American people that to privatize the Social Security system is going to be better for them than a system that has been so deeply respected by generations of Americans.

I think their promise that this Social Security privatization plan is going to help seniors, unfortunately, will be about as realistic as their promise that we could fight a war on terrorism, pass massive tax cuts and balance the budget. In regard to Mr. Portman's comment, I want to commend you, it is irresponsible to not recognize

the cost of replacing the money borrowed from the Social Security trust fund, although I would point out that much of that borrowing occurred because the partisan budget passed much of the Republican leadership in the last 4 years.

But what I would say is, I wish the gentleman had made the statement 4 years ago, or at least listened to Democrats when we were making that statement, saying the cost of long-term Social Security is one of the reasons we needed to take advantage of the surplus of the $276 billion of the Clinton administration era and pay down our Nation's debt.

I think it was irresponsible for Republicans to not listen to Democrats for 4 years who urged our colleagues and said we cannot afford, given our long-term liabilities in this Government, to pass trillion after trillion dollar tax cut that is unpaid for.

In regard to a couple of comments made by Secretary Snow: Mr. Secretary, you said the problem is, we spent too much. Let me just say, for the record—and this is factual—that the Bush administration has proposed significant increases in three of the five largest Federal programs that, out of thousands of programs, represent $2 out of every $3 spent by the Federal Government.

In terms of tax cuts, lending and economic growth, I am not sure that cause and effect has really been proven. It has been alleged. I am not sure it has been proven. But the tradition generally is that, coming out of recessions, you have economic growth.

It kind of reminds me, down in Texas, we have some roosters that think that they are the reason the sun rises in the east, because they crow every day and the sun comes up; not long after that, the sun comes up in the east.

I am not sure that allegation has been proven. But what I do know is that the former Bush administration White House economic official who now heads up the nonpartisan Congressional Budget Office testified after doing a long report on tax cuts and borrowing to pay for them, said that, in the long run, paying for tax cuts by borrowing billions of dollars from American citizens and the communist Chinese and other foreign countries hurts economic growth, not helps economic growth.

So I do not buy into the allegation, unproven, that somehow massive tax cuts paid for by borrowing has somehow led to economic growth.

Mr. Secretary, in terms of Social Security, let me just ask you if you could give me quick yes or no answers or specific answers without elaboration:

When does the Social Security trust fund go insolvent, according to your numbers, what year? Just the year is all I need.

Secretary SNOW. 2042 is the bankruptcy.

Mr. EDWARDS. OK. When does the Medicare trust fund go insolvent, according to your numbers?

Secretary SNOW. I would have to check. I have not viewed the Medicare actuary's report here recently, but it is headed in the same way.

Mr. EDWARDS. But the Secretary full well knows that the Medicare trust fund is going to be insolvent long before the Social Security trust fund.

Now the chairman said his 14-year-old son, according to the charts, will not get Social Security.

Mr. Secretary, factually, if no changes are made in Social Security, and we simply respect the legal obligations we owe the Social Security trust fund, is it, in fact, true that someone in his teens or 20s or 30s will receive no Social Security benefits?

I believe that is a false statement, and it is a myth that is been perpetrated on the younger generation. Isn't it in fact true that Social Security beneficiaries that are in their 20s today—and they become beneficiaries—would actually get somewhere—estimates are 70 to 80 percent of present-day benefits if no changes were made? Isn't that correct?

Secretary SNOW. Yes. I think the trust fund in 2042 can pay out about 70 percent, 72 percent. That declines with——

Mr. EDWARDS. OK. But the statement is, it is simply false, that teenagers and young people in their 20s and 30s would not get any Social Security benefits if we do not change the law. I do not think we ought to build the change on the most important social-problem safety net in the Nation's history based on a false myth.

Mr. PORTMAN [presiding]. Let us see, who is next?

Mr. Bonner for 5 minutes.

Mr. BONNER. Thank you, Mr. Chairman.

Mr. Secretary, it is good to have you here today, and I am glad you are sitting down.

Yesterday, I was reflecting when I was a freshman 2 years ago, when I was sitting on the front row where my friend

Mr. Lungren from California is sitting, and I always had a great view of the witnesses. And the people on this row had a great view of my bald head. So I am glad to have this good view of you today.

I am sad, though, that both yesterday with the OMB director and today, it seems that the talk of bipartisanship and the talk of Democrats and Republicans working together as Americans is nothing more than just that, and that is frustrating. I know it has got to be frustrating to you.

I referred to an article that was in yesterday's Hill newspaper. For now, Democrats will offer no Social Security reforms. It is much as the statements yesterday with OMB director were made. On the one hand, the blasting criticism, waxing nostalgic for the glory years of the Clinton administration when all these surpluses were created, and yet then turning around with the same blasting criticism that all of these cuts are punitive—that the President's budget has proposed—and these cuts are going to be Draconian to the social problems, many of which were created by Great Society in the New Deal.

I think it is frustrating for some of us people on this side to hear people, because we know when we have a vote on the budget, Mr. Edwards, there will be amendment after amendment after amendment offered by members on the other side that will raise money for all of these wonderful programs to put us in an awkward position. Because if we vote against it, then that becomes a campaign commercial back home because we are voting against these programs.

Mr. Secretary, if we do nothing, if we do nothing, and the President could have come to the Congress last week with the State of

the Union and said: Look, I inherited a recession, and we dealt with it, and we have turned it around, and we are now creating jobs and the economy is growing.

We inherited 9/11 because, in a large part, of failed attempts in the past on both sides to take aggressive actions against terrorists, but we inherited 9/11, and we are having to pay for 9/11 now.

Ladies and gentlemen, I am going to take a break. I am not doing to dig deep into this issue. We could have taken a pass on it. Instead, he did not. He is asking the American people to engage us and him in a conversation about what is the best thing to happen about one of America's most sacred programs, Social Security.

So my first question is, if we do nothing, can the young couple that Congressman Wicker is talking about have anything to look forward to other than a measly return on a very significant portion of their paycheck taken out each month?

Secretary SNOW. No. The returns, Congressman, if nothing is done, will be very, very slight.

In fact, for future generations, I think they will be negative, so that you get no return on your payroll taxes. You get a negative amount back.

No, you are right about the President. He came to Washington to solve problems. Not to pass them on to future presidents and future generations. I think he is saying to the Congress, on the Democratic side, on the Republican side: If you do not like my proposals, come up with some other ones. I want to talk to you, I want to have a dialogue on this. I want to find the answers.

Mr. BONNER. In fact, did he not say that in the State of the Union message when he cited several proposals Congressman Penny, Senator Moynihan, President Clinton and others who have made recommendations in the past on Social Security, did he not invite all 435 Members of Congress and the 100 Senators to come up with other proposals as well?

Secretary SNOW. Yes. Yes, he did. I think he truly is reaching out to the Congress for a bipartisan approach to this.

Mr. BONNER. Well, Mr. Secretary, again, I want to thank you for coming up and helping, because there are a lot of questions that we have. This is not an easy subject. But it does not help when people go into any conversation and say that they are close-minded to new opportunities and to new options to consider. To me, if you go into a discussion where you already have said, we are not willing to consider new options, it really says that they are really not looking to solve problems.

Thank you very much, Mr. Secretary.

Secretary SNOW. Thank you, Congressman.

Mr. PORTMAN. Mrs. Capps, for 5 minutes.

Mrs. CAPPS. Thank you, Mr. Chairman.

May I first respond to my colleague on the other side, directly across from me. Mr. Bonner is being critical of our side for not having a proposal and I would only respectfully recall the interchange between our ranking member, Mr. Spratt, and the Secretary, trying to elicit details of the President's proposal. Those details are woefully missing, and it is hard to respond to something which is lacking in substance. So we await further discussion.

But now, Mr. Secretary, thank you for appearing today.

The administration has expressed serious interest in limiting initial benefit levels to the growth at the rate of prices rather than the growth in rate of wages. This would mean a basic benefit cut over the next 50 years of over 40 to 50 percent. Wouldn't this undercut Social Security's ability to help seniors maintain their standard of living in their retirement?

Secretary SNOW. Congresswoman Capps, we have not embraced Model 2, which I think is the Social Security Model 2, which I think is the one that has the index, going from wages to prices. The President did mention that as an option in the State of the Union message along with a variety, a variety of other options.

By going to the Model 2-type solution, you actually overcorrect the problem, as I understand Model 2. It has a solution which is 100 percent plus of the deficiency of the shortfall in Social Security. I do not think we would ever recommend that.

But even Model 2, as long as there are personal accounts giving the retiree, the beneficiary, the chance to come out ahead of where they would if we simply leave the system on automatic.

Mrs. CAPPS. So I hear you saying that model which the President touted in the State of the Union does have serious flaws.

But I want to ask you now about private accounts. You said that—you have said that the basic benefit cut would be made up by the value of these private accounts, which is better than doing nothing, according to your point of view.

What happens to people whose private accounts do not pan out? Maybe they made a bad investment choice or retire at close to a low point in the market.

This would be then tough luck?

Secretary SNOW. Well, then, the investment vehicles would be prudent and safe. They would be quite limited. People would be required to keep their money in those vehicles. They would not be allowed to, you know, as the President says, go off to the roulette wheels or the racetrack with their money. They would have to put it in these safe vehicles, and the vehicle would not be individual bonds or individual equities. They would be—they would be diversified funds of bonds or equities.

Mrs. CAPPS. Well——

Secretary SNOW. Including a so-called life cycle fund that deals with your issue, because the life cycle fund automatically moves the ratio of equity to debt down so that you retire with a lot more debt of fixed income instruments than you do equity, and that mitigates any of those concerns.

Mrs. CAPPS. So it is a different stock market than we know today, perhaps.

I want to ask you about one other point I would like to bring up. Mr. Spratt raised this issue of fully a third of the beneficiaries who are survivors or disabled, a different population than we usually think of when we think of Social Security beneficiaries—many of us fall into that category.

You agree that you cannot realistically cut the benefits of these people; correct? And so if you cannot or do not want to cut their benefits, won't you have to cut the benefits of retirees even more than the 40 to 50 percent Plan 2 envisions to keep the system up? In other words, the beauty of the system that we have today is that

people with disabilities and who are survivors are part of the larger group that is protected in substantial ways?

Secretary SNOW. Right. Well, I think that the Plan 2 has a lot of merit to it. I would not discard it entirely. But it does not—it does not meet the President's principle of protecting the benefits of the disabled. So that is one of the President's core principles, and he would want to see the disabled protected in any legislation that came out.

Mrs. CAPPS. Could I ask for a further explanation of how they would be protected?

Secretary SNOW. Well, there were a variety—there were a variety of means that could be made available to do that, technically dealing with the bend points, technically dealing with the crediting of years, changing the ratios, number of years work, crediting with years worked and so on. So there are a variety of things that can be done. The President's point is, it should be done, and he wants to work with Congress to find out the right way, the best way to do it.

Mrs. CAPPS. But the bottom line would be shifting those costs to—well, those with private accounts?

Secretary SNOW. Well, there are a variety of ways to do it within the system. I think—I do not want to speculate on precisely how it would be done. That would be the result of the ensuing discussion we had hoped to have with you and Members of the Congress.

Mrs. CAPPS. Thank you, Mr. Chairman.

Chairman NUSSLE [presiding]. Mr. Secretary, just for point of clarification—because I have been hearing about this Plan 2—is the President's plan Plan 2?

Secretary SNOW. No, no.

Chairman NUSSLE. OK. I just wanted to make sure because I keep hearing this Plan 2—I see charts; Plan 2 is this, and Plan 2 is that. I mean is it Plan 2 or isn't it Plan 2?

Secretary SNOW. No, sir.

Chairman NUSSLE. I understand you may not have a lot of specifics about—but, I mean, if you know that at least, let us make sure I am——

Secretary SNOW. No. The President in the State of the Union message—I think far from what someone suggested—did lay out a lot of details. The details went to the nature of the problem. He defined the problem. He talked about the declining ratio of people paying into the system to those taking out of the system, going from 40 when it was first established, to 16 in 1950, to 3 today to 2 with the baby boomers. He talked about the nature of the problem.

He then went on to talk in quite a bit of detail about the personal retirement accounts, laid out how they would work.

Then, in addition, he suggested that, in addition to private, to the personal accounts, there were some other things that need to be considered, and he talked about the indexing, and he talked about CPIs, and he talked about things that Members of Congress and, I think, prior presidents have talked about, to put them on the table to say, here are the sorts of things we need to have in the dialogue to put Social Security on a sustainable basis. But he did not embrace commission Plan 2.

Chairman NUSSLE. Thank you.

Mr. Mack for 5 minutes.

Mr. MACK. Thank you, Mr. Chairman.

Thank you, Mr. Snow for being here.

Secretary SNOW. Thank you.

Mr. MACK. It is a great opportunity for me and for my constituents, I think, to talk a little bit about the challenges that are facing us. I think that we are—this is a historic time as it relates to our seniors and also younger workers.

The current system is broken. I hear a lot of talk about, you know, when is it—you know, is it broken now? Is it broken in 18 years? Is it broken then in 2042? When is it broken?

But it is broken, and it needs to be fixed. And I commend the President for taking this issue on. That is exactly what we need in leadership, is someone who is willing to take the tough issues on. It is long overdue, and I believe it needs to include all citizens from every walk of life.

I know that this process will not be short, and I know it will not be easy, but I think the debate is an important one to have, and I think we should all agree to that.

You know, as a parent, I do not believe that I would recommend to my children as they get older to buy a house that is built on a faulty foundation. That just would not be appropriate. It would not be the right thing to do. It would not be a loving thing to do as a parent, to recommend to your children to buy a home that is on a faulty foundation.

I just would like to give you an opportunity, if you would, to talk to us a little bit about the benefits of taking this issue on now instead of waiting for later, as someone suggested to do—you know, let us wait 5, 10, 20, 30 years down the road—talk about the benefits of taking this issue on now and getting this in a sound position now, rather than later.

Secretary SNOW. Congressman, thank you for that, those comments and the question and the opportunity that gives me.

Somebody has said that you do not—as you were suggesting—you do not wait until you are in a crisis to deal with it. You try and anticipate a crisis and avoid it. If you know that the girders in your house, as somebody said, are weak, you do not wait up till they fall down to fix it. You fix it before they fall down. The reason, the reason to deal with this now, of course, is that we have a lot more options available to us. It is less costly to fix it now. The longer we wait, the bigger the problem becomes.

The longer we wait, the more prejudicial the outcome will be. The less beneficial, the more prejudicial the outcome will be to your children and to future generations, because by starting it now, by getting it under way, they will be able to use this power of compounding over a long lifetime of work and thus build much bigger accounts and a much better, a much better retirement.

According to the Social Security actuary, every year we wait, the problem grows by about $600 billion.

Now, even by Washington standards, that is an awful lot of money. To have it growing every year at that rate means that this $10.4 trillion present value obligation becomes larger and larger and larger, overwhelmingly large.

What we are talking about here is the fiscal future of the United States, and the fiscal and the retirement future of future generations. That is what this issue is about. The sooner we get about it, the more we fulfill our obligations, I think, as public servants to both our children, future generations and to the financial and fiscal well-being of our country.

Mr. MACK. Thank you, and what was that number again, $600 billion and what every year?

Secretary SNOW. Billion, rising, the 10.4 is rising, according to the Social Security actuary. These numbers we cite are not our numbers; sometimes people say, "those are your numbers, they are not our numbers." we are using the numbers that come from the actuary of the Social Security Administration, a nonpartisan actuary.

Mr. COOPER. Thank you very much.

Chairman NUSSLE. Mr. Cooper, for 5 minutes.

Mr. COOPER. Thank you, Mr. Chairman.

Mr. Secretary, on page 149 of the December 2001 Presidential Commission on Social Security Reform, they talk about the disability program under Social Security. Many of the comments of my colleagues have talked about the retirement program for Social Security.

Secretary SNOW. Right.

Mr. COOPER. But it is well-known, or should be to everyone, that Social Security really has three benefits: The retirement plan, the survivors benefit, and the disability benefit.

Now this commission in 2001 did a lot of great work. But I believe this is accurate to say that, regarding disability, they were unable to come to a conclusion. They said, in fact, that the benefit was a little bit too complicated for them to deal with.

So I would like to ask you today, since the administration is planning on changing one of its most popular and successful programs in American history, I would like to ask you about that disability element.

If a young person or middle-aged person or older person wanted to go out on the marketplace today, could they buy a benefit, a disability benefit, like the one in Social Security? Could they buy such a benefit from a private company? If so, what would the premium be?

Secretary SNOW. I think disability benefits are available in the open market. It would depend an awful lot on whether you are a violin player, a major league baseball player or you are climbing trees or working off 100-story buildings in New York City.

So it is a little hard to answer the question in the abstract without knowing the details of the individual.

Mr. COOPER. Well, let me get more specific.

Since you are part of an administration proposing this fundamental change for all Americans, what is the valuation you would put today on the benefit that is available under Social Security disability? What is that worth actuarially?

Secretary SNOW. We will see if we have a number. I have not seen the actuary's valuation of the disability benefits implicit in the Social Security system.

But what the President has said—and maybe this cuts to the chase—what the President has said is, he wants to sustain, protect, secure, make safe the disability benefits.

Mr. COOPER. But all the estimates that we have seen involve out-year cuts and benefits, not sustain those benefits, so I think it is crucial for the administration, if they want to change the system, to know the value of what they are changing. It is my understanding—and I do not have the power that a Secretary of the Treasury does—it is my understanding that a disability benefit of this type is unavailable from any commercial source in the world today.

Now, perhaps I am mistaken in that, and perhaps you can find a seller of disability insurance that is as good or better than Social Security is. I would love to have that information. So if you could supply that.

Secretary SNOW. We will. I will check on that, and I will check on the actuary's rendering of the valuation of disabilities as well.

Mr. COOPER. But let me express some concern about your preliminary answer though. You said, if you were to buy a disability today, it might depend on if you were a violinist, had some other job or worked on 100-story buildings.

But one of the great benefits of Social Security is it does not matter what your job is as long as you pay into the system. It protects everybody equally.

Because it is hard to predict, especially in this modern life, what career you are going to have. It is certainly hard to predict your health situation. You were unable to attend a meeting last week because of your health, and that was unexpected.

So the value of that disability benefit has to be valued before the administration takes liberties with it.

Let me ask another question.

Secretary SNOW. I agree with you. Disability is an important, critically important part of Social Security, and we want to sustain the benefits of Social Security.

Mr. COOPER. I see your brain trust behind you. Do any of them have any idea what the current value of the disability is?

Brain trust?

Chairman NUSSLE. Well, this is—the gentleman will suspend. The Secretary has been asked to testify. If he would like to refer to them for an answer, otherwise he has offered to give you that answer in the future.

So we will conduct the hearing here.

Thank you.

Mr. Cooper is recognized for the balance of his time.

Mr. COOPER. Thank you, Mr. Chairman.

Another fundamental area to ask. It is one thing to take the existing Social Security pie and reslice that, and some folks may advocate partial privatization of the system. Others may not.

But basically, you are just reslicing the same pie. What is the administration proposing to actually grow the pie to increase the amount of money that average Americans are able to save every year? Today, we have many wonderful ways of doing that—IRAs; 401(k)s; SEPs; other good savings programs; but many Americans

are not fully utilizing those savings vehicles. What can we do to grow the savings rate in this country?

Secretary SNOW. Probably the single most important thing you can do to grow the savings rate in this country and thus help people have secureretirements is to adopt the President's personal savings account as a part of fixing Social Security.

Mr. COOPER. Mr. Secretary.

Secretary SNOW. That is real savings, that is genuine savings.

Mr. COOPER. No.

Mr. Secretary, under the President's proposal he would take up to 4 percent of what is being paid into the current system. He is not suggesting a plan that would really boost savings and additional vehicles on top of the amount that would be allocated to Social Security. He is just talking about reshuffling that.

Secretary SNOW. In fact he is, Congressman, in fact, in the budget, you will see a section on lifetime savings accounts, retirement savings accounts, employer savings accounts for employees. No, we recognize—as I responded earlier in—on the current account question—we need to encourage more savings in the United States. The budget reflects the need to do that.

But I would say that, in addition to all the things in the budget, the personal retirement accounts that the President is proposing are one other important way, because people will then, say, accumulate, accumulate a nest egg through power of compounding, have more at the end than they otherwise would have; by far, earn rates of return far higher than they could secure under the Social Security system.

Mr. COOPER. You say that as if it were a guarantee.

Chairman NUSSLE. The gentleman's time has expired.

Mr. Hensarling for 5 minutes.

Mr. HENSARLING. Thank you, Mr. Chairman.

Mr. Secretary, I want to start out thanking you and the President. As the father of two in diapers who knows a whole lot more about Barney and Big Bird than Social Security, I cannot tell you how much it warms my heart that somebody is looking out for the next generation and not the next election.

There was an old advertising campaign many, many years ago by a company, I believe, called AAMCO Transmissions. The tag line was: You can pay me now or you can pay me later. I think the idea was that, if you had maintained your transmission and spent a couple of hundred dollars today, the thing would not completely go bust on you so that you would have to pay $2,000 later and replace that transmission.

I am sitting here looking—I am jumping the gun a little bit. But I have a GAO report here. I want to make sure we are all focused on this figure. If I am reading it correctly, our unfunded obligation to Social Security is $10.4 trillion. We were getting into a little bit of discussion of what an administration plan might cost. I have seen other plans that have transition financing, perhaps $1 trillion, a very large sum of money; but last I looked, a whole lot smaller than $10.4 trillion. So, ultimately, to save Social Security, we will be saving not only Social Security, but we will be saving taxpayers money.

Secretary SNOW. Well, absolutely, Congressman. That is a critical point here.

One way to look at this is $10.4 trillion obligation out there, and on a present value basis, you might spend $2 trillion to defease it. What sensible business person would not spend $2 to get $10? That is the reality of what we are doing here. We are defeasing. We are removing a huge overhang liability on the balance sheet of the United States. And in the process we are also creating greater prosperity for future generations.

Mr. HENSARLING. Well, if I could ask you, and my second question here is we have heard a lot of talk of massive borrowing, how that could impact markets in order to save Social Security. If I have done my homework right, over the last 10 years, we as Congress have grown the size of the Government at an average of 4.5 percent a year, which is roughly twice the rate of inflation, and at least 50 percent greater than the family budget is measured by median worker income.

I want to congratulate you and the President again, and the administration for submitting a fiscally responsible budget that will help save the family budget from the Federal budget.

But my question is this: If we could just simply institute some fiscal discipline in this institution, and say we grew Government somewhere in the range of 3 to 3.5 percent a year instead of our traditional pattern of 4.5 percent a year over the last 10 years, and if we managed to save the remaining Social Security surpluses, wouldn't that take us a long way toward coming up with the transition financing to save Social Security?

Secretary SNOW. Well, certainly, if we could hold spending to the sorts of numbers we are talking about and sustain the sort of growth in the economy that we have got that is producing increases in Government receipts at well above the growth levels you are talking about on spending, you would be quickly getting the finances of the United States into strong and good shape. Absolutely.

Mr. HENSARLING. Thank you. My next question. I don't have the chart at my fingertips, but I have seen a chart from GAO before that has persuaded me that my grandparents, who were born at roughly the last turn of the century, received roughly an 11 to 12 percent rate of return on their Social Security. My parents, who were born in the late 1920s, early 1930s, apparently are receiving a roughly 7 percent rate of return on their Social Security. And it is an important part of their retirement. I believe that I am going to receive somewhere in the neighborhood of maybe a 2.5 percent rate of return on my Social Security. My daughter, who is almost three, and my son who is 16 months old, I believe could actually see a negative rate of return.

I guess two questions. One, is that possible? And, if so, what has happened to the security of Social Security if we do that to future generations?

Secretary SNOW. Well, your numbers are right in the ballpark. Early generation did very well. Of course, some of them didn't pay in very long and had long lives, retirement lives, and collected for a long time. This is all really a matter of basic arithmetic, and the arithmetic is compelling. We have gone from having many, many people working and paying for every retiree to having fewer and

fewer, and we are facing now, with the baby boomer retirees coming on stream, having only two people paying in for every retiree.

Now, a pay-as-you-go system—and this is a pay as you go system—works real well when you have got, you know, when you talk about your grandparents there were 50 people paying in for every retiree. And then, you know, back 50 years ago there were 16. Today there are 3. We are going to 2. The system just doesn't hold together. It is a matter of basic arithmetic. And the rates of return of future generations will clearly be negative on the path we are on.

Chairman NUSSLE. Mr. Secretary, it is my understanding you have to be walking out the door at 1:00 p.m., and we are told that we are going to have four, maybe five procedural votes on the floor coming up here at any moment. So what I am going to do is to keep going around to talk to the Secretary here. But when the votes are called, what I will do is I will dismiss the first panel so that you can make your appointment, and we will take the second panel. What we will do with members, unless there is objection, I would like to continue down the row in calling people so that they can continue.

We have a lot of members who want to participate in this, and I don't want to start all over with the senior members and have to work back to you. You have been very patient, our new members in particular. So I would like to continue that, unless I hear a strong objection. So, without objection, we will do that.

Mr. Davis for 5 minutes.

Mr. DAVIS. Thank you, Mr. Chairman, and Mr. Secretary.

Let me if I can go back to a line of questions that the ranking member on this committee pursued with you earlier. The two of you talked about the relative difference in the size of extending the President's tax cuts and of the actual amount of the Social Security shortfall. And your answer was a fairly familiar one. You were saying that if we walk away from extending the tax cuts, that it will cause us economic damage. So I want to test that proposition a little bit.

You agree that we had a pretty robust rate of economic growth from the 1990s, I would assume. Wouldn't you?

Secretary SNOW. Yeah, sure.

Mr. DAVIS. I think your are off the microphone, but I heard you say, yeah, sure. And I agree with you on that.

Secretary SNOW. We had some good growth rates. Unfortunately, they ended in a bad way.

Mr. DAVIS. Well, let me ask you about this then. Right now, the combined level of corporate and income tax as opposed to GDP and the combined rate of corporate and income taxes added together is as I understand it a very low share of the GDP today—a very high share of the GDP today. The combined rate of corporate and income is today a very low share of our GDP relatively speaking.

Secretary SNOW. It is. We have hit—for a variety of reasons it is low, but it is now rising and returning over the course of this budget to its historical level of roughly 18 percent.

Mr. DAVIS. But just to fix the level today, it is actually the lowest combined level since 1942, or since the middle of World War II. Is that not correct?

Secretary SNOW. As a percent of GDP, I think it is about 16 percent, which is low by historical standards, yes.

Mr. DAVIS. Now, in the 1990s, what was the relative rate of income and corporate taxation of GDP?

Secretary SNOW. Well, by the end of the 1990s, given the stock market and the technology bubble, while it lasted, which produced lots of option return and capital gains returns, the tax returns went up to about 21.6 percent of GDP.

Mr. DAVIS. And, again, despite the 21 percent of GDP, we still had a high rate of growth during that time. The reason I make that point is that—and I think if, we went back, Mr. Secretary, you look at 1960s, we had a fairly high rate of growth then. Did we not?

Secretary SNOW. Yeah, we had a pretty good growth rate.

Mr. DAVIS. We also had a very high level of taxation in the 1960s. Didn't we?

Secretary SNOW. Well, thanks to President Kennedy, we got them lower.

Mr. DAVIS. But we still had a relatively high rate of taxation combining corporation and income. In fact, the rate of the 1960s was once again higher than the rate today. In fact, considerably higher than the rate today. Isn't it?

Secretary SNOW. As a percent of GDP.

Mr. DAVIS. Percent of GDP. So, once again, we have the two strongest growth periods since World War II, the 1960s and the 1990s, where we had very high levels of taxation, far higher than the levels of taxation we have today as opposed to GDP. And it is clear that was not enough to check the economic growth. That is an important point, because I think that significantly undermines a good deal of the administration's argument, frankly.

I think all of us would have the perspective, Mr. Secretary, that if we were trading away our economic future, if we were walking away from a recovery if we didn't extend the tax cut, particularly just the top 1 percent, I think a lot of us on this side of the aisle would buy into your arguments. But the problem is, you know, some of us in the room still believe that facts are the best evidence and not just faith. And the facts tell us that the two biggest periods of growth, the 1990s and the 1960s, we had very high levels of taxation, and it apparently did nothing to slow our economy.

Let me move in the limited time I have to another round of questions or to another topic. As I understand the Social Security Administration, they are predicting that the slow, the shortfall of the Social Security between now and 2042, which troubles all of us, is apparently based on a growth rate projection of 1.8 percent. Do you agree or disagree with that?

Secretary SNOW. No, that is right.

Mr. DAVIS. Now, 1.8 percent growth over the next 37 years, can you think of any period since the war where we have had over the course of one decade a growth rate of 1.8 percent?

Secretary SNOW. Yes.

Mr. DAVIS. What would that be?

Secretary SNOW. That number which comes from the actuary, as I remember what the actuary said, the 1.8 is basically the productivity number for the 40 or 45 year period.

Mr. DAVIS. But is there any comparable period, Mr. Secretary, where we have had—because that is a very anemic growth.

Secretary SNOW. That is it, that is the 45-year period.

Mr. DAVIS. But is there any period since 1945—and I am thinking in terms of decades, where we have had growth that has been that anemic? And the proposition that I make, if the Chair will indulge me just 15 seconds to sum up. If we had that kind of a growth rate over the next several years, Mr. Secretary, over the 30-some years I should say, it strikes me that it would mean that our economy was in dire straits. And of course, if our economy were in dire straits, it follows for some of us that the stock market would probably be underperforming. So it is very curious that the administration that is always optimistic about growth is basing its Social Security program on a growth rate line of 1.8 percent, far worse than we have had in our recent experiences, and incredibly willing to gamble our seniors on Social Security being invested in the stock market. Can you respond to that?

Secretary SNOW. Oh, sure. I would be delighted to, because I think there is a huge misconception implicit in what you just said.

The stock market correlates with productivity. There is a recent study by a professor, I think at the University of California who looks at over a 40, 50-year period the stock market and what it correlates with. And the stock market best correlates over any long period of time with productivity per capita.

What is happening for the—and the actuary uses in that 1.8, I think 1.6 of that 1.8 which is GDP, 1.6 of the 1.8 is the productivity. The point two is population. Now of course the population growth of the United States is slowing, but the productivity growth according to the actuary, which is based on the prior 45 years, is the same.

Mr. DAVIS. But 1.8 is still a very slow growth rate.

Secretary SNOW. No, it not. 1.8 is the historic 45-year average productivity growth rate in the United States economy which has produced the returns to the stock market we have seen over that period. So the correlation is one to one.

Chairman NUSSLE. Mr. Simpson for 5 minutes.

Mr. SIMPSON. Thank you, Mr. Chairman.

And I appreciate you being here today, Mr. Secretary, and taking the time to discuss this issue with us. First of all, in relation to what Mr. Davis said, it was interesting as I listened to that. I was over in Ireland earlier this year, talked to some of the officials over there, several of them. And they told me that about 15 years ago Ireland had the lowest per capita income in the European Union. They currently have the second highest per capita income in the EU next to Luxembourg. And I said, what did you do to change that outcome? And they said, we sat down and made some really tough decisions, and that is that we were taxing our people too much, that we were—that it would cost too much to produce in this country, and we made some tough choices. And we went through some very difficult times, but it has changed our economy around, and essentially every major corporation in the country now has a—in the world, has a company located in Ireland.

So, and I think you are on the right track. And I appreciate—you know, this is something we have known ever since Adam

Smith, but we haven't always followed it. But I appreciate the track that you are on and what you are doing for the economy.

Secretary SNOW. I visited there, myself, sometime back, and got a first-hand conversation with the people who created the so-called Celtic miracle, and they talked about where they were two decades back and the transformation that has occurred, largely because they embraced Adam Smith and market practices and low tax rates.

Mr. SIMPSON. Right. I appreciate that. One of the things that concerns me is the rhetoric that is surrounding all this proposal, and in fact the American people out there are very confused about whether there actually is a problem with Social Security or not. Because when we start talking about the actual problem, we start talking about our favored plan to solve that problem and it gets mixed up with it, or the cause of the problem, or whatever. What is the administration doing? I appreciate the fact that the President has been out on the stump the last while, and ultimately we respond to voters.

What are we doing to try to educate the American public to the nature of the problem? Because, to me, we have got to have a discussion with the American people about their retirement system, and also not only that it is their system but that it is a—as was mentioned by the chairman earlier, it is not their total retirement system, it is supposed to be supplemental retirement, and they need to also be saving for retirement in other areas.

Too many people have depended on Social Security for their total retirement fund and figured, well, the Government will take care of that. I don't have to worry about retirement anymore. And somehow we have got to change that attitude. But we have to do, I think, a good job somehow of engaging the American people in this discussion. And unfortunately what happens right now is you have got the American senior citizens who are very engaged in this subject who the President says this won't affect; and I find it interesting that it is 55 and older that are not going to have their benefits affected and then we talk about the younger people.

I am 54, I am worried. But we have to, the American senior citizen is engaged because they obviously depend on Social Security. The younger generation is not real engaged in this discussion because, just like I am sure you and the rest of us, we didn't care about Social Security when we were first entering the workforce, but they had better start caring about it relatively soon.

How are we going to engage them?

Secretary SNOW. Well, Congressman, you put your finger on a critical issue here. I think the President knows he has got an obligation to lead this, to get out and use the bully pulpit and talk to the American people and really engage them on the problem and be straight with them, be honest with them, tell them the facts and get the facts out. You know, America is a Nation of problem solvers, we are a Nation of fixers, but we first have to understand what the problem is. That is why this hearing today, the other hearings are so important to get the facts out. And I am glad to hear people from both sides of the aisle agreeing that there is a problem, because that is where the solution starts, with identifying the problem.

This is only going to be addressed when the American people say there is a problem and we want answers. And the President knows he has to take that message to the American people. He has asked us in the cabinet to do it, but he knows he has to lead that effort.

Mr. SIMPSON. Do you think there is broad consensus about what the problem exactly is?

Secretary SNOW. I think there is a growing understanding of what the problem is, the demographics which are—this is all about arithmetic, it is not about ideology. It is simple, straightforward arithmetic. Nobody can repeal the laws of arithmetic. And the laws of arithmetic are dooming Social Security on its present course. And the sooner we act to fix it, the better the chances. I think that more and more people—I wouldn't say it is fully understood by any means, but more and more people are beginning to get a sense of the dimensions of the problem and the need to act on it, and I think they are going to be asking their elected representatives around the country, what are you doing?

Mr. SIMPSON. Well, I hope so. I have spent the last 2 years actually talking about the problem we have with entitlement spending and how that is driving really the budget deficit and a few other things, and Social Security particularly. And I have found that any number of people have come up afterwards and said I appreciate the fact that you are talking about that because I really didn't understand it before. So I appreciate the fact that you are engaged in this and the President is engaged in this. It is something that would be so easy for us to put off for another 10 years.

Chairman NUSSLE. I am going to call on Mr. Allen for 5 minutes, a quick 5 minutes, and then Mr. Bradley for 5 minutes, and then we will wrap up. We have as I understand a couple votes on the floor. Mr. Allen for 5 minutes.

Mr. ALLEN. Thank you, Mr. Chairman.

And thank you, Mr. Secretary, for being here. If I were trying to summarize your testimony so far, I would say that you are saying that mathematics is not important. There is basic math involved here. You don't know the details of the President's proposal, but you certainly know it includes private accounts. You don't know how much money will have to be borrowed after the first 10 years, but you do know it will save taxpayers money and it will be better, that younger people will be better off.

What I take from this is the conclusion has been arrived at before the mathematics has been done. We are not talking about model two, but we are talking about something close to model two. We don't know all the details, we don't know how many trillions of dollars will be borrowed. But just to look at one analysis based on Social Security Administration economic assumptions—I would like to have chart 4 put up on the screen, and I will come back to that in a moment. I mean, just to take one—we will wait for that to come up.

Now, you have said that you know that the plan will take care of the long-term Social Security liability, but you don't know how much borrowing the plan requires after the first 10 years. It is those kinds of conflicts which makes some of us really skeptical.

The second point I would say is that what I hear you saying is that deficits really—I think you are saying that deficits really mat-

ter between now and 2009. And we have to knock down the deficit from that estimated inflated, I would argue, level of $521 billion. But after 2009, it is OK to borrow trillions and trillions of dollars. As you may remember, your predecessor, Paul O'Neill had a little disagreement with the President over the 2003 tax cuts. And Vice President Cheney said to Mr. O'Neill that Ronald Reagan proved that deficits don't matter. But Mr. O'Neill's advice to the President was, if you pass the 2003 tax cuts, if you do that, you will not be able to do anything else that you want to do including, specifically he was concerned about privatizing Social Security because he is a believer in privatization.

Yesterday, Josh Bolten was here and said that it is all OK, we don't have exact numbers but it is OK. This new idea of borrowing to save instead of borrowing to spend, he checked it out with some Wall Street analysts; you are telling us today you have checked it out with some Wall Street analysts, and also with Treasury analysts, it is OK, it is fine. Of course, someone on Wall Street is going to make billions of dollars in all probability from this plan. But thinking about my friends from the other side of the aisle, when it comes to estimates from this administration—today's Washington Post says: Medicare drug benefit may cost $1.2 trillion.

Now, we have been through here before with estimates from the administration, and, frankly, particularly Republicans were sandbagged when the administration refused to give them—or us for that matter—the true estimated cost of the administration when it came to the cost of the Medicare benefit, which is exploding in cost. The American people are going to need more than someone standing up and saying Wall Street analysts say this is OK. Aren't they?

Secretary SNOW. Well, I hope you don't think that is all we are saying, Congressman.

Mr. ALLEN. It is all I have heard. It is all I have heard about the source of the confidence as to the fact that borrowing $5 or $6 trillion in the first 20 years is not going to suck money out of the private capital markets. It seems to me it is inevitably going to suck money out of the private capital markets, drive up interest rates, and slow down the economy.

Secretary SNOW. Remember what is happening here. Remember what is happening. The structure of what is happening is essential to keep in mind. People will be taking money that otherwise would go into Social Security. Right? And they will be putting it into these private accounts. As they remove money from Social Security, they also give up a future claim on Social Security.

Mr. ALLEN. Their benefits will be cut.

Secretary SNOW. They give up, the liability of the United States goes down by the amount of the money that is diverted. So from the Social Security point of view, this is not a cost to the Social Security system. But from the point of view of the balance sheet of the United States and the American economy, the money that is diverted is put into savings. It helps the savings. Net savings is not adversely affected. In fact, I think it would be positively affected.

Chairman NUSSLE. Mr. Bradley for 5 minutes.

Mr. BRADLEY. Thank you very much, Mr. Chairman.

Mr. Snow, just two quick questions, please, if I might. My home State which is New Hampshire ranks second highest in the per-

centage of the population between the ages of 34 and 54. Could you just outline for me what the administration's thinking is as to how the personal accounts proposed are going to be structured to ensure that these middle-aged workers—and I guess with my gray hair I am getting almost beyond that—who don't have the same amount of time as younger workers, for instance Mr. Hensarling's children, will be able to build up their portfolios? That is question number one.

And number two. There was a recent article last week in The Wall Street Journal about other country's experiences with personal accounts. Could you just touch on some of the issues that have arisen with regard to other countries and how you are incorporating that into your thinking?

Secretary SNOW. Right. Well, on the 34 to 54 age cohorts, any reduction in benefits we have said would have to be gradual so that they wouldn't face a sharp dropoff in their benefits and they would be able to help offset those benefits reductions with the personal accounts. One reason to start this soon is that that group of people will then have more time. Every year we put it off, they have one less year to get the virtue of compounding.

I will be glad to share with you some research the Treasury has done on the variety of countries who have put in place approaches that are called personal accounts. They vary a lot and therefore it is hard to come up with one overall conclusion. The article that was in the paper that got some prominent feature on Chile, I think sort of badly distorted the reality of what has happened in Chile and did not reflect the real facts. But I will be happy to send you our analysis of—and many, many, many countries. The United States is in a way not in the forefront but one of the later countries to come to the use of personal accounts, the market investments to help augment retirement. But I will be glad to do that.

Mr. BRADLEY. Thank you. And I will yield my time.

Ms. MCKINNEY. Mr. Chairman, inasmuch as I haven't had an opportunity to address the Secretary, I would like to ask unanimous consent that I have a statement submitted for the record.

Chairman NUSSLE. The gentlelady is—and would the gentlelady like to ask? I have got time for one question. You will get the last word. If you have one question you would like to ask? But certainly without objection, your statement will be part of the record, as is true for all members, without objection.

Ms. MCKINNEY. Well, thank you very much, Mr. Chairman, for the indulgence.

I have a series of newspaper articles about the Senator Frist political fund losing, as they say, big time in the stock market. The Tennessean newspaper, the Washington Post reported that after big losses in the stock market, U.S. Senate Majority Leader Bill Frist campaign committee was short of money and couldn't make its loan.

Now, Mr. Secretary, you are suggesting that the guaranteed retirement benefit in Social Security be replaced with a system that could yield for the average participant a result like Senator Frist. My question is, what happens then to the person whose investment goes bust?

Secretary SNOW. Congresswoman, thank you for that question. I think the President in the State of the Union message made it clear that these would be safe investment vehicles. This wouldn't be investments in individual stocks, it wouldn't be investments in options or hedge funds or trade or derivatives, anything like that. It is very important that these funds be deployed in a way that is safe and secure, and the investment vehicle that would be designed to accomplish that is very much like the investment vehicle available to you as a Government public official, the so-called Thrift Savings Plan. This would have some other features to it though.

Ms. MCKINNEY. But what I have is in addition, the Thrift Savings Plan is in addition to the Social Security. So what you are proposing is instead of.

Secretary SNOW. But you are asking me the nature of the investment opportunities, and the nature of the investment opportunities would be the same sort of safe and secure investment opportunities that you have through your savings plan.

Ms. MCKINNEY. But the benefit is—the guaranteed benefit is definitely not guaranteed under your plan.

Secretary SNOW. No. This is an opportunity for people to invest in bonds and stocks; and there is no guarantee on bonds and stocks except that over time they tend to do very, very, very well relative to the return you would get in the——

Ms. MCKINNEY. So the average taxpayer's personal accounts could end up like Senator Frist's; it could go bust.

Secretary SNOW. That is extraordinarily unlikely.

Ms. MCKINNEY. Thank you, Mr. Chairman.

Chairman NUSSLE. I thank the gentlelady.

Mr. Secretary, thank you for indulging us your time today. I will dismiss this panel. And when we resume after the series of votes we will resume with panel two. The committee stands in recess. [Recess.]

We will resume the Budget Committee hearing. We are pleased to welcome our second panel to the witness table. We have before us today the two very distinguished public servants, who in their own right, deserve their own panel, to be quite honest. Typically we ask the two of them to give us their information singularly. We are asking them to do it today together because, quite frankly, have both of you have given us some ideas and sounded the alarms and suggested that we need to tackle these problems in many different ways.

So I think, if there is any time to put the two of you together and, as they say, put your heads together, we have got two of the best thinkers that provide information to our Congress on our panel. We are pleased to have both of you here today.

STATEMENTS OF HON. DAVID M. WALKER, COMPTROLLER GENERAL, GOVERNMENT ACCOUNTABILITY OFFICE; AND DOUGLAS J. HOLTZ-EAKIN, Ph.D., DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Chairman NUSSLE. By a coin flip and going in alphabetical order, we will call on Douglas Holtz-Eakin. Or you would like to go first? We will do it that way. We will go in reverse alphabetical order and call on David Walker, the Comptroller General of the Govern-

ment Accountability Office. Welcome, General, and we are pleased to receive your testimony. Your entire testimony will be made a part of the record.

STATEMENT OF HON. DAVID M. WALKER

Mr. WALKER. Thank you, Mr. Chairman. It is good to be back before the House Budget Committee, this time to speak about our Nation's Social Security program. I appreciate you putting my entire statement in the record. I will summarize some key points.

I think it is important for the members to know at the outset that, in addition to working on this issue at GAO in my capacity as Comptroller General of the United States, I was also a trustee of Social Security and Medicare from 1990 to 1995, so I am very deep on these issues and care about them very much.

As I have testified on many times before Congress, Mr. Chairman, the Social Security system faces both a solvency and a sustainability challenge over the longer term. And while the Social Security program does not face an immediate crisis, it does have a $3.7 trillion gap in current dollar terms between promised and funded benefits. This gap is growing daily; and given this and other major fiscal challenges that face the country, it would be prudent to act sooner than later to reform the Social Security program. Failure to take steps to address our large and structural long-range fiscal imbalance which is driven largely by projected increases in Medicare, Medicaid, and Social Security spending, will ultimately have significant adverse effects on our country, children, and grandchildren. If I can, let me make a few key points.

In looking at Social Security, several key points are important. First, solving Social Security's long-term financing problem is more important and complex than merely making the numbers add up. It is important to keep in mind that Social Security is not only a program for retirement income, but also a program for disabled workers and for survivors of deceased workers. It is important to keep all those dimensions in mind.

Secondly, and the first chart (chart 1). Social Security reform is part of a broader fiscal economic challenge. We need to keep this in context with regard to the larger challenges that we face. This chart shows one scenario in GAO's long-range budget simulations. This one is based on CBO's baseline projection; you can see that we face large and growing structural deficits in the out years due largely to known demographic trends and rising health care costs.

If you look at the simulation, you have to keep in mind three things. First, it is bound by the constraints imposed on CBO's 10-year baseline. Those relevant to this simulation are, number one, that no new laws will be passed. Number two, that discretionary spending will grow by inflation. And, number three, that all tax cuts will sunset as scheduled.

So even under those assumptions you can see that we have a problem which increases with time, the white line being revenue as a percentage of GDP, the bar being spending as a percentage of GDP.

The next one (chart 2), however, is much more sobering and dramatic. The only two differences between this one and the next one are number one, discretionary spending grows by the rate of the

economy throughout the period. And, number two, all tax cuts are made permanent.

Under the second scenario, the only thing that the Federal Government can do in the year 2040 or slightly beyond is pay interest on massive debt. That is obviously not an acceptable outcome. Next, please (chart 3).

It is important to keep in mind that you can't just look at trust fund solvency alone. After all, the trust funds are nothing more than an accounting device. They are not true fiduciary trust funds. If you look on the financial statements of the U.S. Government, you will not find a liability of the U.S. Government owing to the trust funds. Further, the trust fund does not tell us whether or not the program is sustainable; it doesn't tell us how much of a burden the program represents on future budgets or on the economy. So it is important to keep in mind cash flows because cash is of critical importance. We have already turned a negative cash flow in Medicare Part A. That happened last year in 2004. We are projected to turn a negative cash flow in Social Security/OASDI combined in 2018, and it will get progressively worse every year thereafter.

I think it is also important to note that acting sooner rather than later will help to ease the difficulty in achieving reforms. Not only will you not have to make dramatic changes, but people have more time to adjust to whatever changes that you make.

Just as importantly, by acting sooner, we can send a positive signal to the markets that will enhance our credibility that the Government is willing to act to deal with known long-range challenges before they reach crisis proportions. Furthermore, it would hopefully give elected officials the confidence necessary to take on truly more difficult challenges. Because Medicare is eight times worse than Social Security. Candidly, Medicare is going to be a lot tougher to solve. It is going to take many years, and you are going to have to do it in installments.

Last, is it is very important to keep in mind that any Social Security reform proposals need to be evaluated as packages. There are going to be pros and cons of every Social Security reform proposal. It is also important to keep in mind that not all promised benefits are funded. And, therefore, it is not fair to compare reform proposals solely to promised benefits. They must be compared to both funded benefits and promised benefits to understand the relative trade-offs. And, in doing that, I would respectfully suggest to the committee that you consider the work that GAO has done for the Congress in this regard. We basically recommend analyzing Social Security reform proposals as a package against those two benchmarks and based on three criteria: Whether and to what extent the proposal will achieve sustainable solvency, not just over 75 years but for the long term; whether or not it meets the standard of adequacy and equity; and, whether or not it can be implemented and administered in a feasible and a cost effective manner.

In summary, Mr. Chairman, Social Security may not be in a crisis, but it has a large and growing financing problem. It would be prudent to act sooner rather than later because, candidly, Social Security should be easy lifting as compared to the other work that has to be done. The Congress has an opportunity to exceed the expectations of every generation of Americans with or without indi-

vidual accounts. I realize that is an issue that is going to be debated. In any event, individual accounts would have to be part of a comprehensive reform package in order to achieve the objectives that I outlined earlier. But with or without individual accounts you can exceed the expectations of every generation. I hope that the Congress will act. Thank you, Mr. Chairman.

[The prepared statement of David M. Walker follows:]

PREPARED STATEMENT OF HON. DAVID M. WALKER, COMPTROLLER GENERAL, U.S. GOVERNMENT ACCOUNTABILITY OFFICE

Mr. Chairman and Members of the Committee, I appreciate the opportunity to talk with you about our nation's Social Security program[1] and how to address the challenges presented in ensuring the long-term viability of this important social insurance system. Social Security provides a foundation of retirement income for millions of Americans and has prevented many former workers and their families from living their retirement years in poverty. Fixing Social Security is about more than finances. It is also about maintaining an adequate safety net for American workers against loss of income from retirement, disability, or death.

As I have said in congressional testimonies over the past several years, the Social Security system faces both solvency and sustainability challenges in the longer term.[2] While the Social Security program does not face an immediate crisis, it does have a $3.7 trillion gap between promised and funded benefits in current dollar terms. This gap is growing daily and, given this and other major fiscal challenges including expected growth in Federal health spending, it would be prudent to act sooner rather than later to reform the Social Security program. Failure to take steps to address our large and structural long-range fiscal imbalance, which is driven in large part by projected increases in Medicare, Medicaid, and Social Security spending, will ultimately have significant adverse consequences for our country, children, and grandchildren.

Let me begin by highlighting a number of important points concerning the Social Security challenge and our broader fiscal and economic challenge.

- Solving Social Security's long-term financing problem is more important and complex than simply making the numbers add up. Social Security is an important and successful social insurance program that affects virtually every American family. It currently pays benefits to more than 47 million people, including retired workers, disabled workers, the spouses and children of retired and disabled workers, and the survivors of deceased workers. The number of individuals receiving benefits is expected to grow to almost 69 million by 2020. The program has been highly effective at reducing the incidence of poverty among the elderly, and the disability and survivor benefits have been critical to the financial well-being of millions of others.
- Social Security reform is part of a broader fiscal and economic challenge. If you look ahead in the Federal budget, Social Security together with the rapidly growing health programs (Medicare and Medicaid) will dominate the Federal Government's future fiscal outlook. While this hearing is not about the complexities of Medicare, it is important to note that Medicare presents a much greater, more complex, and more urgent fiscal challenge than Social Security. Medicare growth rates reflect not only a burgeoning beneficiary population, but also the escalation of health care costs at rates well exceeding general rates of inflation. Taken together, Social Security, Medicare, and Medicaid represent an unsustainable burden on future generations. Furthermore, any changes to Social Security should be considered in the context of the problems currently facing our nation's private pension system. These include the chronically low level of coverage of the private workforce, the continued decline in defined benefit plans coupled with the termination of large underfunded plans by bankrupt firms, and the shift by employers to defined contribution plans, where workers face the potential for greater return but also assume greater financial risk.
- Focusing on trust fund solvency alone is not sufficient. We need to put the program on a path toward sustainable solvency. Trust fund solvency is an important concept, but focusing on trust fund solvency alone can lead to a false sense of security about the overall condition of the Social Security program. After all, the Social Security Trust Fund is a subaccount of the Federal Government rather than a private trust fund. Its assets are not readily marketable nor are they convertible into cash other than through raising revenues, cutting other Government expenses, or increasing debt held by the public. Furthermore, the size of the trust fund does not tell us whether the program is sustainable—that is, whether the Government will have the capacity to pay future claims or what else will have to be squeezed to pay

those claims. Aiming for sustainable solvency would increase the chance that future policymakers would not have to face these difficult questions on a recurring basis. Estimates of what it would take to achieve 75-year trust fund solvency understate the extent of the problem because the program's financial imbalance gets worse in the 76th and subsequent years.

• Acting sooner rather than later helps to ease the difficulty of change. The challenge of facing the imminent and daunting budget pressure from Medicare, Medicaid, and Social Security increases over time. Social Security will begin to constrain the budget long before the trust fund is exhausted in 2042. The Social Security cash surpluses that are now helping to finance the rest of the Government's budgetary needs will begin to decline in 2008, and by 2018, the cash surpluses will turn to deficits. Social Security's cash shortfall will place increasing pressure on the rest of the budget to raise the resources necessary to meet the program's costs. Waiting until Social Security faces an immediate trust fund solvency crisis will limit the scope of feasible solutions and could reduce the options to only those choices that are the most difficult. It could also contribute to a further delay of the really tough decisions on Federal health programs. Acting sooner rather than later would allow changes to be more modest while also being phased in so that future retirees will have time to adjust their retirement planning. Furthermore, acting sooner rather than later would serve to increase our credibility with the markets and improve the public's confidence in the Federal Government's ability to deal with our significant long-range fiscal challenges before they reach crisis proportions.

• Reform proposals should be evaluated as packages. The elements of any reform proposal interact; every package will have pluses and minuses, and no plan will satisfy everyone on all dimensions. If we focus on the pros and cons of each element of reform by itself, we may find it impossible to build the bridges necessary to achieve consensus. Analyses of reform proposals should reflect the fact that the program faces a long-term actuarial deficit and that benefit reduction and/or revenue increases will be necessary to restore solvency. This requires looking at proposed reforms from at least two perspectives or benchmarks—one that raises revenue to fund currently scheduled benefits (promised benefits) and one that adjusts benefits to a level supported by current tax financing (funded benefits).

Today, the Social Security program does not face an immediate crisis, but rather a long-range financing problem driven by demographic trends. While the crisis is not immediate, the challenge is more urgent than it may appear since the program will experience increasing negative cash flow starting in 2018. Acting soon to address these problems reduces the likelihood that Congress will have to choose between imposing severe benefit cuts and unfairly burdening future generations with the program's rising costs. Acting soon would also allow changes to be phased in so the individuals who are most likely to be affected, namely younger and future workers, will have time to adjust their retirement planning while helping to avoid related "expectation gaps." On the other hand, failure to take remedial action will, in combination with other entitlement spending, lead to a situation unsustainable both for the Federal Government and, ultimately, the economy.

Today we have an opportunity to address the relatively easier part of the overall entitlement challenge before the baby boom generation begins to retire and the challenge begins to compound. Medicare represents a much larger driver of the long-term fiscal outlook, but this does not mean that Social Security reform should be postponed until after it is addressed. On the contrary, it argues for moving ahead on Social Security soon. Unlike the case in health care, potential approaches to Social Security reform have already been articulated in various proposals in recent years. These approaches can serve as a starting point for deliberations. Since health care will be much harder to address, there is a significant danger that if we do not move ahead on Social Security now, we could end up reforming neither. Successful Social Security reform could also help build both trust and confidence and thereby facilitate consideration of the needed structural changes in the health care system.

The Social Security system has required changes in the past to ensure its future solvency. Congress took action to address an immediate solvency crisis in 1983. While such an immediate crisis will not occur for many years, waiting until it is imminent will not be prudent. Furthermore, I believe it is possible to craft a solution that will protect Social Security benefits for the nation's current and near-term retirees, while ensuring that the system will be there for future generations. I believe that it is possible to reform Social Security in a way that will assure the program's solvency and sustainability while exceeding the expectations of all generations of Americans.

SOCIAL SECURITY REFORM IS PART OF A BROADER FISCAL AND ECONOMIC CHALLENGE

In my role as lead partner on the audit of the U.S. Government's consolidated financial statements and the de facto Chief Accountability Officer of the U.S. Government, I have become increasingly concerned about the state of our nation's finances. In speeches and presentations over the past several years, I have called attention to our large and growing long-term fiscal challenge and the risks it poses to our nation's future.[3] Simply put, our nation's fiscal policy is on an unsustainable course, and our long-term fiscal imbalance worsened significantly in 2004. GAO's simulations—as well as those of the Congressional Budget Office (CBO) and others—show that over the long term we face a large and growing structural deficit due primarily to known demographic trends and rising health care costs. Continuing on this unsustainable fiscal path will gradually erode, if not suddenly damage, our economy, our standard of living, and ultimately our national security. Our current path also will increasingly constrain our ability to address emerging and unexpected budgetary needs.

Regardless of the assumptions used, all simulations indicate that the problem is too big to be solved by economic growth alone or by making modest changes to existing spending and tax policies. Nothing less than a fundamental reexamination of all major spending and tax policies and priorities is needed. This reexamination should also involve a national discussion about what Americans want from their Government and how much they are willing to pay for those things. This discussion will not be easy, but it must take place.

In fiscal year 2004 alone, the nation's fiscal imbalance grew dramatically, primarily due to enactment of the new Medicare prescription drug benefit, which added $8.1 trillion to the outstanding commitments and obligations of the U.S. Government. The near-term deficits also reflected higher defense, homeland security, and overall discretionary spending which exceeded growth in the economy, as well as revenues which have fallen below historical averages due to policy decisions and other economic and technical factors.

While the nation's long-term fiscal imbalance grew significantly, the retirement of the baby boom generation has come closer to becoming a reality. In fact, the cost implications of the baby boom generation's retirement have already become a factor in CBO's baseline projections and will only intensify as the boomers age. According to CBO, total Federal spending for Social Security, Medicare, and Medicaid is projected to grow by about 25 percent over the next 10 years—from 8.4 percent of gross domestic product (GDP) in 2004 to 10.4 percent in 2015. Given these and other factors, it is clear that the nation's current fiscal path is unsustainable and that tough choices will be necessary in order to address the growing imbalance.

There are different ways to describe the magnitude of Social Security's long-term financing challenge, but they all show a need for program reform sooner rather than later. A case can be made for a range of different measures, as well as different time horizons. For instance, the shortfall can be measured in present value, as a percentage of GDP, or as a percentage of taxable payroll. The Social Security Administration (SSA) has made projections of the Social Security shortfall using different time horizons. (See table 1.)

Table 1: Different Measures, Same Challenge

Projection Horizon	SSA's Projections of Unfunded OASDI Obligations		
	Present value	Percent of GDP	Percent of payroll
75 year	$3.7 Trillion	0.7%	1.8%
Infinite horizon	$10.4 Trillion	1.2%	3.5%

Source: SSA.

Note: Data from Social Security Administration, *The 2004 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Fund* (Washington, D.C., March 2004).

While estimates vary due to different horizons, both identify the same long-term challenge: The Social Security system is unsustainable in the long run. Taking action soon on Social Security would not only make the necessary action less dramatic than if we wait but would also promote increased budgetary flexibility in the future and stronger economic growth.

Although the Trustees' 2004 intermediate estimates project that the combined Social Security Trust Funds will be solvent until 2042,[4] within the next few years, Social Security spending will begin to put pressure on the rest of the Federal budget. (See table 2.) Under the Trustees' 2004 intermediate estimates, Social Security's cash surplus—the difference between program tax income and the costs of paying scheduled benefits—will begin a permanent decline in 2008. (See fig. 1.) To finance the same level of Federal spending as in the previous year, additional revenues and/or increased borrowing will be needed in each subsequent year.

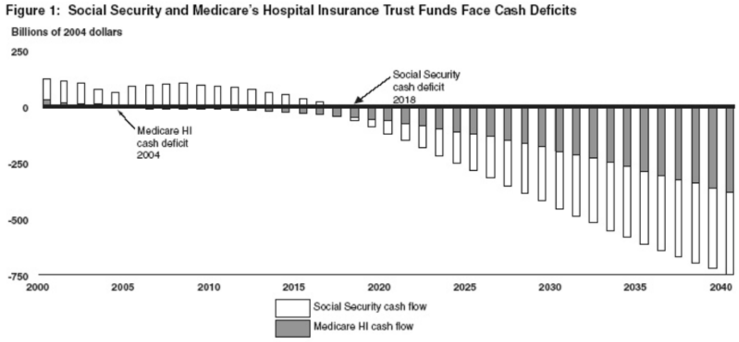
Table 2: Key Dates Highlight Long Term Challenges of the Social Security System

Date	Event
2008	Social Security cash surplus begins to decline
2018	Annual benefit costs exceed cash revenue from taxes
2028	Trust fund ceases to grow because even taxes plus interest fall short of benefits
2042 (SSA) 2052 (CBO)	Trust fund exhausted, annual revenues sufficient to pay about 73% – 81% of promised benefits

Sources: SSA and CBO.

Note: Data from Social Security Administration, *The 2004 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds* (Washington, D.C., March 2004) and Congressional Budget Office, *The Outlook for Social Security: Potential Range of Social Security Outlays and Revenues Under Current Law* (Washington, D.C., June 2004).

Figure 1: Social Security and Medicare's Hospital Insurance Trust Funds Face Cash Deficits



Source: GAO analysis based on data from the Office of the Chief Actuary, Social Security Administration and Office of the Actuary, Centers for Medicare and Medicaid Services.

Note: Projections based on the intermediate assumptions of the 2004 Trustees' Reports.

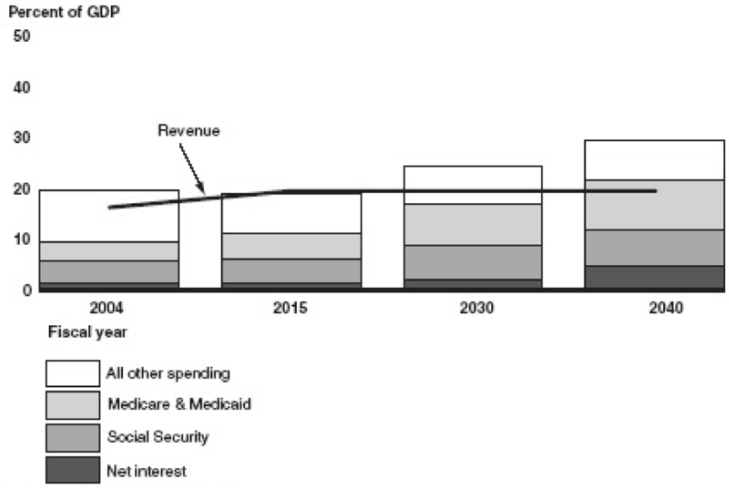
By 2018,[5] Social Security's cash income (tax revenue) is projected to fall below program expenses. At that time, Social Security will join Medicare's Hospital Insurance Trust Fund, whose outlays exceeded cash revenues in 2004, as a net claimant on the rest of the Federal budget. The combined OASDI Trust Funds will begin drawing on the Treasury to cover the cash shortfall. At this point, Treasury will need to obtain cash for those redeemed securities either through increased taxes, and/or spending cuts, and/or more borrowing from the public than would have been the case had Social Security's cash flow remained positive.

Today Social Security spending exceeds Federal spending for Medicare and Medicaid, but that will change. While Social Security is expected to grow about 5.6 percent per year on average over the next 10 years, Medicare and Medicaid combined are expected to grow at 8.5 percent per year. As a result, CBO's baseline projects Medicare and Medicaid spending will be about 30 percent higher than Social Security in 2015. According to the Social Security and Medicare trustees, Social Security will grow from 4.3 percent of GDP today to 6.6 percent in 2075, and Medicare's burden on the economy will quintuple—from 2.7 percent to 13.3 percent of the economy.

GAO's long-term simulations illustrate the magnitude of the fiscal challenges associated with an aging society and the significance of the related challenges the Government will be called upon to address. Figures 2 and 3 present these simulations under two different sets of assumptions. In figure 2, we begin with CBO's January baseline, constructed according to the statutory requirements for that baseline.[6] Consistent with these requirements, discretionary spending is assumed to grow with inflation for the first 10 years and tax cuts scheduled to expire are assumed to expire. After 2015, discretionary spending is assumed to grow with the economy, and revenue is held constant as a share of GDP at the 2015 level. In figure 3 two assumptions are changed: discretionary spending is assumed to grow with the economy after 2005 rather than merely with inflation and the tax cuts are extended. For both simulations Social Security and Medicare spending is based on the

2004 Trustees' intermediate projections, and we assume that benefits continue to be paid in full after the trust funds are exhausted. Medicaid spending is based on CBO's December 2003 long-term projections under mid-range assumptions.

Figure 2: Composition of Spending as a Share of Gross Domestic Product (GDP) under Baseline Extended

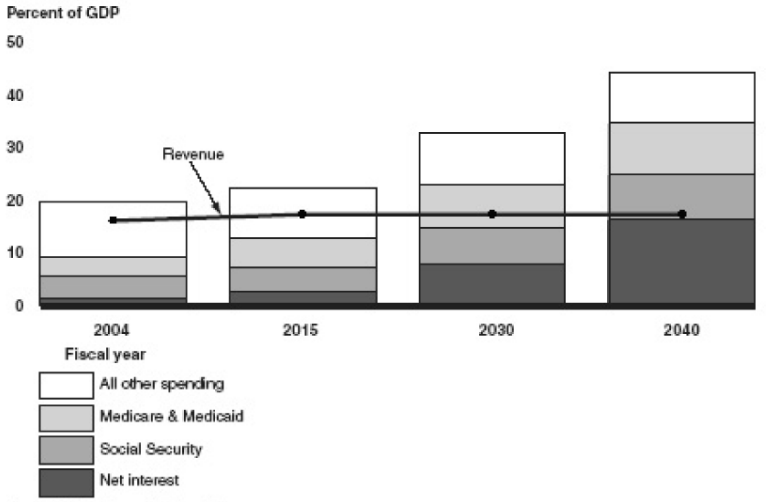


Source: GAO's January 2005 analysis.

Notes: In addition to the expiration of tax cuts, revenue as a share of GDP increases through 2015 due to (1) real bracket creep, (2) more taxpayers becoming subject to the AMT, and (3) increased revenue from tax-deferred retirement accounts. After 2015, revenue as a share of GDP is held constant.

Both these simulations illustrate that, absent policy changes, the growth in spending on Federal retirement and health entitlements will encumber an escalating share of the Government's resources. Indeed, when we assume that recent tax reductions are made permanent and discretionary spending keeps pace with the economy, our long-term simulations suggest that by 2040 Federal revenues may be adequate to pay little more than interest on the Federal debt. Neither slowing the growth in discretionary spending nor allowing the tax provisions to expire—nor both together—would eliminate the imbalance. Although revenues will be part of the debate about our fiscal future, the failure to reform Social Security, Medicare, Medicaid, and other drivers of the long-term fiscal gap would require at least a doubling of taxes—and that seems implausible. Accordingly, substantive reform of Social Security and our major health programs remains critical to recapturing our future fiscal flexibility.

Figure 3: Composition of Spending as a Share of GDP Assuming Discretionary Spending Grows with GDP after 2005 and All Expiring Tax Provisions Are Extended

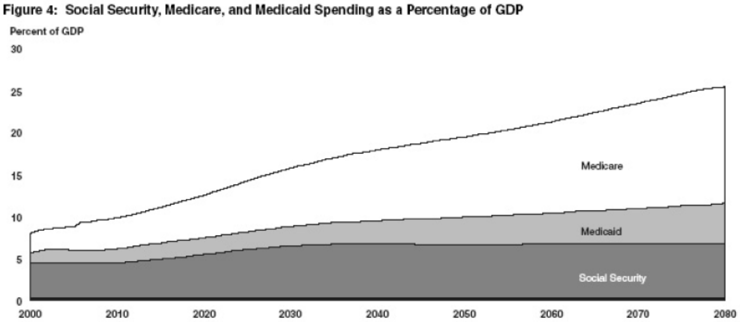


Source: GAO's January 2005 analysis

Notes: Although expiring tax provisions are extended, revenue as a share of GDP increases through 2015 due to (1) real bracket creep, (2) more taxpayers becoming subject to the AMT, and (3) increased revenue from tax-deferred retirement accounts. After 2015, revenue as a share of GDP is held constant.

Although considerable uncertainty surrounds long-term budget projections, we know two things for certain: the population is aging and the baby boom generation is approaching retirement age. The aging population and rising health care spending will have significant implications not only for the budget but also for the economy as a whole. Figure 4 shows the total future draw on the economy represented by Social Security, Medicare, and Medicaid. Under the 2004 Trustees' intermediate estimates and CBO's long-term Medicaid estimates, spending for these entitlement programs combined will grow to 15.6 percent of GDP in 2030 from today's 8.5 percent. It is clear that, taken together, Social Security, Medicare, and Medicaid represent an unsustainable burden on future generations.

Figure 4: Social Security, Medicare, and Medicaid Spending as a Percentage of GDP



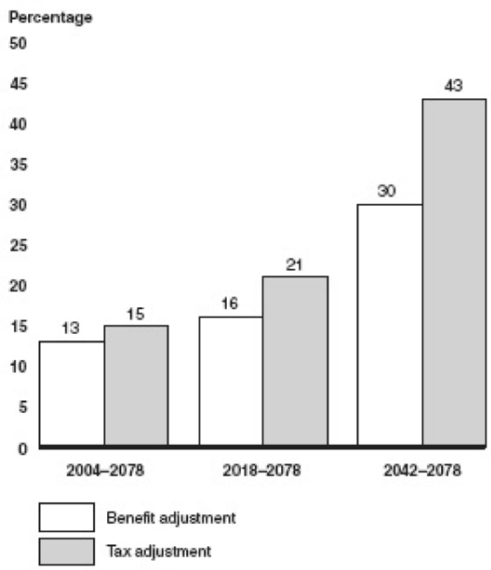
Source: GAO analysis based on data from the Office of the Chief Actuary, Social Security Administration, Office of the Actuary, Centers for Medicare and Medicaid Services, and the Congressional Budget Office.

Note: Social Security and Medicare projections based on the intermediate assumptions of the 2004 Trustees' Reports. Medicaid projections based on CBO's January 2005 short-term Medicaid estimates and CBO's December 2003 long-term Medicaid projections under mid-range assumptions.

The Government can help ease future fiscal burdens through spending reductions or revenue actions that reduce debt held by the public, thereby saving for the future and enhancing the pool of economic resources available for private investment and long-term growth. Economic growth can help, but given the size of our projected fiscal gap we will not be able to simply grow our way out of the problem. Closing the current long-term fiscal gap would require sustained economic growth far beyond that experienced in U.S. economic history since World War II. Tough choices are inevitable, and the sooner we act the better.

Some of the benefits of early action—and the costs of delay—can be illustrated using the 2004 Social Security Trustees' intermediate projections. Figure 5 compares what it would take to keep Social Security solvent through 2078 by either raising payroll taxes or reducing benefits. If we did nothing until 2042—the year SSA estimates the Trust Funds will be exhausted—achieving actuarial balance would require changes in benefits of 30 percent or changes in taxes of 43 percent. As figure 5 shows, earlier action shrinks the size of the necessary adjustment.

Figure 5: Size of Action Needed to Achieve Social Security Solvency



Source: Office of the Chief Actuary, Social Security Administration.

Note: This is based on the intermediate assumptions of the *2004 Social Security Trustees Report*. The benefit adjustments in this graph represent a one-time, permanent change to all existing and future benefits beginning in the first year indicated. Estimates cover the time period from January 1st of the first year to December 31, 2078.

Both sustainability concerns and solvency considerations drive us to act sooner rather than later. Trust Fund exhaustion may be nearly 40 years away, but the squeeze on the Federal budget will begin as the baby boom generation begins to retire. Actions taken today can ease both these pressures and the pain of future actions. Acting sooner rather than later also provides a more reasonable planning horizon for future retirees.

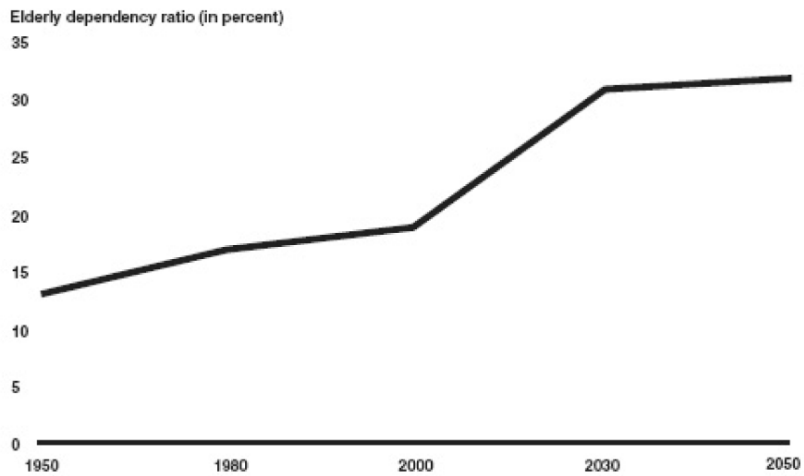
DEMOGRAPHIC TRENDS DRIVE BOTH THE LONG-TERM FISCAL OUTLOOK AND SOCIAL SECURITY'S FINANCING CHALLENGE

The Social Security program's situation is but one symptom of larger demographic trends that will have broad and profound effects on our Nation's future in other ways as well. As you are aware, Social Security has always been a largely pay-as-you-go system. This means that the system's financial condition is directly affected by the relative size of the populations of covered workers and beneficiaries. Histori-

cally, this relationship has been favorable to the system's financial condition. Now, however, people are living longer and spending more time in retirement.

As shown in figure 6, the U.S. elderly dependency ratio is expected to continue to increase.[7] The proportion of the elderly population relative to the working-age population in the U.S. rose from 13 percent in 1950 to 19 percent in 2000. By 2050, there is projected to be almost 1 elderly dependent for every 3 people of working age—a ratio of 32 percent. Additionally, the average life expectancy of males at birth has increased from 66.6 in 1960 to 74.3 in 2000, with females at birth experiencing a rise from 73.1 to 79.7 over the same period. As general life expectancy has increased in the United States, there has also been an increase in the number of years spent in retirement. Improvements in life expectancy have extended the average amount of time spent by workers in retirement from 11.5 years in 1950 to 18 years for the average male worker as of 2003.

Figure 6: U.S. Elderly Dependency Ratio Is Expected to Continue to Increase

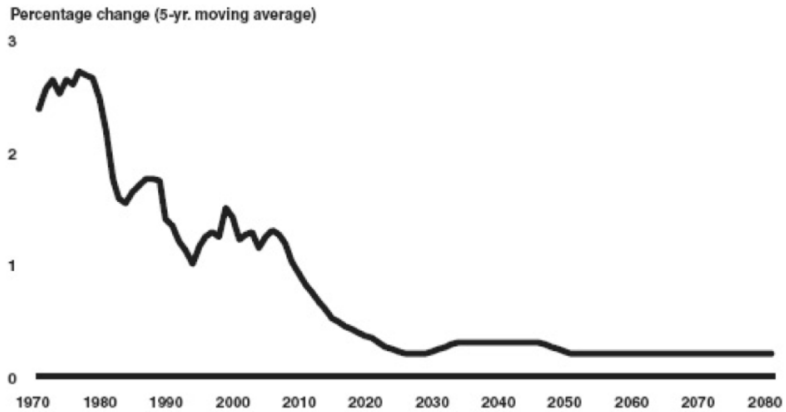


Source: Population Division of the Department of Economic and Social Affairs of the United Nations Secretariat, World Population Prospects: 2002 Revision, and World Urbanization Prospects: 2001 Revision.

A falling fertility rate is the other principal factor underlying the growth in the elderly's share of the population. In the 1960s, the fertility rate, which is the average number of children that would be born to women during their childbearing years, was an average of 3 children per woman. Today it is a little over 2, and by 2030 it is expected to fall to 1.95—a rate that is below what it takes to maintain a stable population. Taken together, these trends threaten the financial solvency and sustainability of Social Security.

The combination of these factors means that annual labor force growth will begin to slow after 2010 and by 2025 is expected to be less than a fifth of what it is today. (See fig. 7.) Relatively fewer workers will be available to produce the goods and services that all will consume. Without a major increase in productivity or increases in immigration, low labor force growth will lead to slower growth in the economy and to slower growth of Federal revenues. This in turn will only accentuate the overall pressure on the Federal budget.

Figure 7: Labor Force Growth Is Expected to Slow Significantly



Source: GAO analysis of data from the Office of the Chief Actuary, Social Security Administration.

Note: Percentage change is calculated as a centered 5-yr. moving average of projections based on the intermediate assumptions of the 2004 Trustees Reports.

The aging of the labor force and the reduced growth in the number of workers will have important implications for the size and composition of the labor force, as well as the characteristics of many jobs, throughout the 21st century. The U.S. workforce of the 21st century will be facing a very different set of opportunities and challenges than that of previous generations.

Increased investment could increase the productivity of workers and spur economic growth. However, increasing investment depends on national saving, which remains at historically low levels. Historically, the most direct way for the Federal Government to increase saving has been to reduce the deficit (or run a surplus). Although the Government may try to increase personal saving, results of these efforts have been mixed. For example, even with the preferential tax treatment granted since the 1970s to encourage retirement saving, the personal saving rate has steadily declined. Even if economic growth increases, the structure of retirement programs and historical experience in health care cost growth suggest that higher economic growth results in a generally commensurate growth in spending for these programs in the long term.[8]

In recent years, personal saving by households has reached record lows while at the same time the Federal budget deficit has climbed. (See fig. 8.) Accordingly, national saving has diminished but the economy has continued to grow in part because more and better investments were made. That is, each dollar saved bought more investment goods and a greater share of saving was invested in highly productive information technology. The economy has also continued to grow because the United States was able to invest more than it saved by borrowing abroad, that is, by running a current account deficit. However, a portion of the income generated by foreign-owned assets in the United States must be paid to foreign lenders. National saving is the only way a country can have its capital and own it too.

Figure 8: Personal Saving Rate Has Steadily Declined

Source: Bureau of Economic Analysis.

In general, saving involves trading off consumption today for greater consumption tomorrow. Our budget decisions today will have important consequences for the living standards of future generations. The financial burdens facing the smaller cohort of future workers in an aging society would most certainly be lessened if the economic pie were enlarged. This is no easy challenge, but in a very real sense, our fiscal decisions affect the longer-term economy through their effects on national saving.

The persistent U.S. current account deficits of recent years have translated into a rising level of indebtedness to other countries. However, many other nations currently financing investment in the United States also will face aging populations and declining national saving, so relying on foreign savings to finance a large share of U.S. domestic investment or Federal borrowing is not a viable strategy in the long run.

HEALTH CARE IS A LARGER AND MORE DIFFICULT CHALLENGE THAN SOCIAL SECURITY

As figure 4 showed, over the long term Medicare and Medicaid will dominate the Federal Government's future fiscal outlook. Medicare growth rates reflect not only a burgeoning beneficiary population but also the escalation of health care costs at rates well exceeding general rates of inflation. Health care generally presents not only a much greater but a more complex challenge than Social Security. The structural changes needed to address health care cost growth will take time to develop, and the process of reforming health care is likely to be an incremental one.

While the long-term fiscal challenge cannot be successfully addressed without addressing Medicare and Medicaid, Federal health spending trends should not be viewed in isolation from the health care system as a whole. For example, Medicare and Medicaid cannot grow over the long term at a slower rate than cost in the rest of the health care system without resulting in a two-tier health care system. This, for example, could squeeze providers who then in turn might seek to recoup costs from other payers elsewhere in the health care system. Rather, in order to address the long-term fiscal challenge, it will be necessary to find approaches that deal with health care cost growth in the overall health care system.

Although health care spending is the largest driver of the long-term fiscal outlook, this does not mean that Social Security reform should be postponed until after health is addressed. On the contrary, it argues for moving ahead on Social Security now. The outlines of Social Security reform have already been articulated in many Social Security reform proposals. These approaches and the specific elements of reform are well known and have been the subject of many analyses, including GAO reports and testimonies. Reform approaches already put forward can serve as a starting point for deliberations.

CONSIDERATIONS IN ASSESSING REFORM OPTIONS

As important as financial stability may be for Social Security, it cannot be the only consideration. As a former public trustee of Social Security and Medicare, I am well aware of the central role these programs play in the lives of millions of Americans. Social Security remains the foundation of the Nation's retirement system. It is also much more than just a retirement program; it pays benefits to disabled workers and their dependents, spouses and children of retired workers, and survivors of deceased workers. In 2004, Social Security paid almost $493 billion in benefits to more than 47 million people. Since its inception, the program has successfully reduced poverty among the elderly. In 1959, 35 percent of the elderly were poor. In 2000, about 8 percent of beneficiaries aged 65 or older were poor, and 48 percent would have been poor without Social Security. It is precisely because the program is so deeply woven into the fabric of our nation that any proposed reform must consider the program in its entirety, rather than one aspect alone. To assist policymakers, GAO has developed a broad framework for evaluating reform proposals that considers not only solvency but other aspects of the program as well. Our criteria aim to balance financial and economic considerations with benefit adequacy and equity issues and the administrative challenges associated with various proposals.

GAO FRAMEWORK FOR EVALUATING REFORM PROPOSALS

The analytic framework GAO has developed to assess proposals comprises three basic criteria:

- Financing Sustainable Solvency—the extent to which a proposal achieves sustainable solvency and how it would affect the economy and the Federal budget. Our sustainable solvency standard encompasses several different ways of looking at the Social Security program's financing needs. While a 75-year actuarial balance has generally been used in evaluating the long-term financial outlook of the Social Security program and reform proposals, it is not sufficient in gauging the program's solvency after the 75th year. For example, under the trustees' intermediate assumptions, each year the 75-year actuarial period changes, and a year with a surplus is replaced by a new 75th year that has a significant deficit. As a result, changes made to restore trust fund solvency only for the 75-year period can result in future actuarial imbalances almost immediately. Reform plans that lead to sustainable solvency would be those that consider the broader issues of fiscal sustainability and affordability over the long term. Specifically, a standard of sustainable solvency also involves looking at (1) the balance between program income and costs beyond the 75th year and (2) the share of the budget and economy consumed by Social Security spending.
- Balancing Adequacy and Equity—the relative balance struck between the goals of individual equity and income adequacy. The current Social Security system's benefit structure attempts to strike a balance between these two goals. From the beginning, Social Security benefits were set in a way that focused especially on replacing some portion of workers' preretirement earnings. Over time other changes were made that were intended to enhance the program's role in helping ensure adequate incomes. Retirement income adequacy, therefore, is addressed in part through the program's progressive benefit structure, providing proportionately larger benefits to lower earners and certain household types, such as those with dependents. Individual equity refers to the relationship between contributions made and benefits received. This can be thought of as the rate of return on individual contributions. Balancing these seemingly conflicting objectives through the political process has resulted in the design of the current Social Security program and should still be taken into account in any proposed reforms.
- Implementing and Administering Proposed Reforms—how readily a proposal could be implemented, administered, and explained to the public. Program complexity makes implementation and administration both more difficult and harder to explain. Some degree of implementation and administrative complexity arises in virtually all proposed changes to Social Security, even those that make incremental changes in the already existing structure. Although these issues may appear technical or routine on the surface, they are important issues because they have the potential to delay—if not derail—reform if they are not considered early enough for planning purposes. Moreover, issues such as feasibility and cost can, and should, influence policy choices. Continued public acceptance of and confidence in the Social Security program require that any reforms and their implications for benefits be well understood. This means that the American people must understand why change is necessary, what the reforms are, why they are needed, how they are to be implemented and administered, and how they will affect their own retirement income. All reform proposals will require some additional outreach to the public so

that future beneficiaries can adjust their retirement planning accordingly. The more transparent the implementation and administration of reform, and the more carefully such reform is phased in, the more likely it will be understood and accepted by the American people.

The weight that different policymakers place on different criteria will vary, depending on how they value different attributes. For example, if offering individual choice and control is less important than maintaining replacement rates for low-income workers, then a reform proposal emphasizing adequacy considerations might be preferred. As they fashion a comprehensive proposal, however, policymakers will ultimately have to balance the relative importance they place on each of these criteria. As we have noted in the past before this committee and elsewhere, a comprehensive evaluation is needed that considers a range of effects together. Focusing on comprehensive packages of reforms will enable us to foster credibility and acceptance. This will help us avoid getting mired in the details and losing sight of important interactive effects. It will help build the bridges necessary to achieve consensus.

REFORM'S POTENTIAL EFFECTS ON THE SOCIAL SECURITY PROGRAM

A variety of proposals have been offered to address Social Security's financial problems. Many proposals contain reforms that would alter benefits or revenues within the structure of the current defined benefits system. Some would reduce benefits by modifying the benefit formula (such as increasing the number of years used to calculate benefits or using price indexing instead of wage indexing), reduce cost-of-living adjustments (COLA), raise the normal and/or early retirement ages, or revise dependent benefits. Some of the proposals also include measures or benefit changes that seek to strengthen progressivity (e.g., replacement rates) in an effort to mitigate the effect on low-income workers. Others have proposed revenue increases, including raising the payroll tax or expanding the Social Security taxable wage base that finances the system; increasing the taxation of benefits; or covering those few remaining workers not currently required to participate in Social Security, such as older state and local government employees.

A number of proposals also seek to restructure the program through the creation of individual accounts. Under a system of individual accounts, workers would manage a portion of their own Social Security contributions to varying degrees. This would expose workers to a greater degree of risk in return for both greater individual choice in retirement investments and the possibility of a higher rate of return on contributions than available under current law. There are many different ways that an individual account system could be set up. For example, contributions to individual accounts could be mandatory or they could be voluntary. Proposals also differ in the manner in which accounts would be financed, the extent of choice and flexibility concerning investment options, the way in which benefits are paid out, and the way the accounts would interact with the existing Social Security program—individual accounts could serve either as an addition to or as a replacement for part of the current benefit structure.

In addition, the timing and impact of individual accounts on the solvency, sustainability, adequacy, equity, net savings, and rate of return associated with the Social Security system varies depending on the structure of the total reform package. Individual accounts by themselves will not lead the system to sustainable solvency. Achieving sustainable solvency requires more revenue, lower benefits, or both. Furthermore, incorporating a system of individual accounts may involve significant transition costs. These costs come about because the Social Security system would have to continue paying out benefits to current and near-term retirees concurrently with establishing new individual accounts.

Individual accounts can contribute to sustainability as they could provide a mechanism to prefund retirement benefits that would be immune to demographic booms and busts. However, if such accounts are funded through borrowing, no such prefunding is achieved. An additional important consideration in adopting a reform package that contains individual accounts would be the level of benefit adequacy achieved by the reform. To the extent that benefits are not adequate, it may result in the Government eventually providing additional revenues to make up the difference.

Also, some degree of implementation and administrative complexity arises in virtually all proposed changes to Social Security. The greatest potential implementation and administrative challenges are associated with proposals that would create individual accounts. These include, for example, issues concerning the management of the information and money flow needed to maintain such a system, the degree of choice and flexibility individuals would have over investment options and access to their accounts, investment education and transitional efforts, and the mecha-

nisms that would be used to pay out benefits upon retirement. The Federal Thrift Savings Plan (TSP) could serve as a model for providing a limited amount of options that reduce risk and administrative costs while still providing some degree of choice. However, a system of accounts that spans the entire national workforce and millions of employers would be significantly larger and more complex than TSP or any other system we have in place today.

Another important consideration for Social Security reform is assessing a proposal's effect on national saving. Individual account proposals that fund accounts through redirection of payroll taxes or general revenue do not increase national saving on a first order basis. The redirection of payroll taxes or general revenue reduces Government saving by the same amount that the individual accounts increase private saving. Beyond these first order effects, the actual net effect of a proposal on national saving is difficult to estimate due to uncertainties in predicting changes in future spending and revenue policies of the Government as well as changes in the saving behavior of private households and individuals. For example, the lower surpluses and higher deficits that result from redirecting payroll taxes to individual accounts could lead to changes in Federal fiscal policy that would increase national saving. On the other hand, households may respond by reducing their other saving in response to the creation of individual accounts. No expert consensus exists on how Social Security reform proposals would affect the saving behavior of private households and businesses.

Finally, the effort to reform Social Security is occurring as our Nation's private pension system is also facing serious challenges. Only about half of the private sector workforce is covered by a pension plan. A number of large underfunded traditional defined benefit plans-

• plans where the employer bears the risk of investment—have been terminated by bankrupt firms, including household names like Bethlehem Steel, US Airways, and Polaroid. These terminations have resulted in thousands of workers losing promised benefits and have saddled the Pension Benefit Guaranty Corporation, the Government corporation that partially insures certain defined benefit pension benefits, with billions of dollars in liabilities that threaten its long-term solvency. Meanwhile, the number of traditional defined benefit pension plans continues to decline as employers increasingly offer workers defined contribution plans like 401(k) plans where, like individual accounts, workers face the potential of both greater return and greater risk. These challenges serve to reinforce the imperative to place Social Security on a sound financial footing which provides a foundation of certain and secure retirement income.

Regardless of what type of Social Security reform package is adopted, continued confidence in the Social Security program is essential. This means that the American people must understand why change is necessary, what the reforms are, why they are needed, how they are to be implemented and administered, and how they will affect their own retirement income. All reform proposals will require some additional outreach to the public so that future beneficiaries can adjust their retirement planning accordingly. The more transparent the implementation and administration of reform, and the more carefully such reform is phased in, the more likely it will be understood and accepted by the American people.

CONCLUSIONS

Social Security does not face an immediate crisis but it does face a large and growing financial problem. In addition, our Social Security challenge is only part of a much broader fiscal challenge that includes, among other things, the need to reform Medicare, Medicaid, and our overall health care system.

Today we have an opportunity to address Social Security as a first step toward improving the Nation's long-term fiscal outlook. Steps to reform our Federal health care system are likely to be much more difficult. They are also likely to require a series of incremental actions over an extended period of time. As I have said before, the future sustainability of programs is the key issue policy makers should address—i.e., the capacity of the economy and budget to afford the commitment over time. Absent substantive reform, these important Federal programs will not be sustainable. Furthermore, absent reform, younger workers will face dramatic benefit reductions or tax increases that will grow over time.

Many retirees and near retirees fear cuts that would affect them in the immediate future while young people believe they will get little or no Social Security benefits in the longer term. I believe that it is possible to reform Social Security in a way that will ensure the program's solvency, sustainability, and security while exceeding the expectations of all generations of Americans.

ENDNOTES

1. In this statement, Social Security refers to the Old-Age and Survivors Insurance and Disability Insurance (OASDI) program.
2. GAO, Budget Issues: Long-Term Fiscal Challenges, GAO-02-467T (Washington, D.C.: Feb. 27, 2002); Social Security: Long-Term Financing Shortfall Drives Need for Reform, GAO-02-845T (Washington, D.C.: June 19, 2002); and Social Security: Long-Term Challenges Warrant Early Action, GAO-05-303T (Washington, D.C.: Feb. 3, 2005).
3. Saving Our Nation's Future: An Intergovernmental Challenge, Outlook 2005 Conference, The National Press Club (Washington D.C.: Feb. 2, 2005). This product can be found on GAO's web site, *www.gao.gov*.
4. Separately, the Disability Insurance (DI) fund is projected to be exhausted in 2029 and the Old-Age and Survivors' Insurance (OASI) fund in 2044. Using slightly different economic assumptions and model specifications, CBO estimated the combined Social Security trust fund will be solvent until 2052. See Congressional Budget Office, The Outlook for Social Security (Washington, D.C.: June 2004) and Updated Long-Term Projections for Social Security (Washington, D.C.: January 2005).
5. CBO estimates that this will occur in 2020. See CBO's Updated Long-Term Projections for Social Security (January 2005).
6. The Congressional Budget Office, The Budget and Economic Outlook: Fiscal Years 2006 to 2015, (Washington, D.C.: January 2005).
7. The elderly dependency ratio is the ratio of the population aged 65 years or over to the population aged 15 to 64.
8. Initial Social Security benefits are indexed to nominal wage growth resulting in higher benefits over time.

Chairman NUSSLE. To your credit, if I may amplify your testimony, this is not the first time you have given us this advice. We appreciate that.

Mr. WALKER. Thank you.

Chairman NUSSLE. Doug Holtz-Eakin, the Director of the Congressional Budget Office. We welcome you back to the committee, and we are pleased to receive your testimony. All of your statement will be made part of the record.

STATEMENT OF DOUGLAS J. HOLTZ-EAKIN

Mr. HOLTZ-EAKIN. Thank you, Mr. Chairman, and members of the committee. The CBO is happy to be back to talk about this important issue and to continue to work with the committee on this and other areas. I wanted to simply submit the testimony as we have it written and talk about this program, which is very important from many perspectives, and bring to the discussion not merely a discussion of the system's finances, but the larger perspective of the economy, where the Social Security program is very important to beneficiaries in deciding their labor supply, how much they work and when they retire, where it is central to decisions on saving for retirement and the kind of portfolios people hold at the moment, where it has a big contribution to retirement income along with private saving and private pension plans, and where it has important implications for the distribution of well-being between parents and their children.

It is one of the central pieces of economic policymaking in the United States. It is also a very important budgetary issue. It is our single largest Federal program at the moment and should be analyzed from budgetary perspectives as well.

I thought I would devote my time to talking about three figures which outline the future of the Social Security program and shed light on the nature of the problem facing this committee from a

budgetary and economic perspective. If we could look at the first of those.

This summarizes the current CBO projections for the outlook for Social Security under the current law. It may differ in numerical detail from those you would hear from my colleague to the right or from those in the Social Security Administration. However, qualitatively, we all have the same message about the outlook for the program. And that is, that at the moment revenues dedicated to Social Security exceed the outlays for benefits to current retirees. And that will continue and grow, in fact, until shortly after the retirement of the leading edge of the baby boom generation.

Beginning in about 2010, that excess will begin to diminish. It diminishes steadily in our projections until 2020, at which point the cash flow surplus switches to a cash flow deficit. At that point, Social Security is entitled to continue to pay full benefits, the red line, which will exceed dedicated revenues, the blue line, for decades. And those benefits will be paid in full from resources drawn elsewhere in the Federal budget. They will come from either lower spending elsewhere in the Federal budget, higher taxes, or greater borrowing from the public.

In our projections, the trust fund, the accounting mechanism that gives the legal authority to pay full benefits will exhaust in 2052, at which point there will be an across-the-board 22 percent diminishment in the ability to pay benefits, and the program can then continue paying out benefits equal to payroll taxes thereafter.

That suggests a couple of things. Number one, in terms of timing, some form of the current Social Security program can in fact be sustained indefinitely, and that is the edge at the right where benefits are brought down to payroll taxes.

In terms of other issues of urgency, whether things need to be done sooner or later, it is in the eye of the beholder. At some point, 2052 would be the across-the-board benefit cut. Others would point to 2020 in our projections when cash flow surplus turns to cash flow deficit. Others would note that surplus peaks in 2010, and that between 2010 and 2025, we will swing from providing $100 billion from Social Security to the remainder of the budget to $100 billion in today's dollars from the remainder of the budget for Social Security, and that budgetary pressure should be the driving consideration in reform. Any of those I think are plausible dates, and in the context of the larger Federal budget all will be noticeable events for this committee.

If we go to slide two. This simple display also I think displays the size of the problem. There are many different measures of what is deemed to be how large a problem we have. To my eye, the size of the problem is illustrated by the fact that scheduled benefits under current law, the outlay line on top in red exceeds dedicated revenues under current law, the blue line at the bottom, as far as the eyes can see. And all measures that you will hear about the size of the problem have to do with adding up over different horizons and for different people the size of that gap between the outlays and the revenues. From a larger budgetary point of view, one could make the arithmetic case that we simply do not have a Social Security problem. That we can honor the benefit promises at the top. But I would note that, as a matter of arithmetic, if one makes

that case, they must simultaneously make the case that they can find those resources elsewhere in the Federal budget and solve the larger looming problem that we face and that David illustrated so nicely.

The third thing this shows us, if we go to slide three, is the difference between two notions of fixing the problem. One notion of fixing the problem that one hears quite frequently is fixing it in a 75-year actuarial balance sense. CBO's estimates are that over 75 years the actuarial imbalance is a bit above 1 percent of taxable payroll. That would suggest that the problem is fixed if one simply raises, for example, the payroll tax by 1 percentage point and has that as the solution to Social security. That is the rise in blue line from the bottom one to the dotted one above it. You will notice that, from a budgetary point of view, this diminishes but does not eliminate the cash flow shortfall between promised benefits and dedicated revenues.

A different way to say is that any actuarial fix comes with it a budget financing plan, a dedication of future cash flows that must come out of the remainder of the Federal budget through either less borrowing or some other source that makes good on that 75 year actuarial fix. It is also the case that once you get to the end of 75 years, you have a problem remaining, this is not a sustainable fix in every sense.

All of this will come to pass in an environment in which there will be even greater budgetary demands from other programs. So to the extent that you adopt a fix for Social Security, it must be developed in the context of rising demands for Medicare and Medicaid that will dwarf the rising outlays for Social Security. Social Security's outlays are likely to go up by about 50 percent, it is a fraction of GDP; Medicare and Medicaid, if things go well, may triple in size and could in fact be quite large.

These are the budgetary problems that face this committee and the Congress as a whole as it faces Social Security. I would remind everyone in closing that these budgetary futures will be a reflection of economic policy issues, and that the threshold questions are whether this Social Security system is the one that the Congress wants for the 21st century, whether it is designed appropriately for a world in which there are very different demographics, where fertility is much different than it was at the time the program was put into place, where longevity is rising, and where the dependency ratio, as a result, is much greater.

And in looking at the program, the new element that has been raised is the possibility of individual accounts. And there, I would suggest, that in addition to the financing considerations that we have heard so much about already today, one remember the economic policy considerations; that to the extent that one favors individual accounts and prefunding in that form, it is an argument in favor of increased reliance on individuals, in enhancing labor supply incentives in this program, in enhancing savings incentives in the program, and offering participants a potential for a higher rate of return.

In contrast, those who favor a modification of a pay-as-you-go Social Security system for the new demographics are highlighting the importance of universality in the program, the ability to redis-

tribute through Social Security, and to offer genuine social insurance in which the retirement benefit is decoupled from the particulars of someone's labor market experience. These are important economic policy issues. They will reflect themselves in the budget and in Social Security more narrowly, and we look forward to working with the Congress in helping you as you make these decisions. Thank you, Mr. Chairman.

[The prepared statement of Douglas J. Holtz-Eakin follows:]

PREPARED STATEMENT OF DOUGLAS HOLTZ-EAKIN, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Chairman Nussle, Congressman Spratt, and Members of the Committee, I appreciate the opportunity to appear before you today to discuss the Social Security system. Discussions about reforming the system have focused on the program and its trust funds. But important insights can also be gained by looking at Social Security from the perspectives of the economy and the Federal budget as a whole.

First, from the perspective of the economy, beneficiaries make decisions about when to retire and how much to work before retirement partly on the basis of the amount of taxes they pay and the amount of benefits they expect to receive. Social Security also influences people's decisions about how much to save, and that saving plays a role in determining the size not only of people's retirement income but also of the Nation's capital stock as a whole. Consequently, Social Security has important implications for aggregate economic performance for the flow of income that the economy will be able to generate and for the total stock of wealth and overall economic resources that will be available in the future. As a result, Social Security can significantly affect the Nation's standard of living as well as the distribution of income within and among generations.

Second, from a budgetary standpoint, Social Security is the single largest program of the Federal Government. This fiscal year, outlays for Social Security are expected to top $500 billion and account for 23 percent of total Federal spending (excluding interest). Looking further ahead, the Congressional Budget Office (CBO) projects that Social Security outlays will grow from 4.2 percent of gross domestic product (GDP) in 2005 to 6.5 percent in 2050. Although that growth is significant, it pales in comparison with the projected growth of the Government's two big health programs, Medicare and Medicaid.

Finally, Social Security can be analyzed from the perspective of the program itself. The most recent programmatic focus has been on the "sustainability" of the system's finances. However, several other aspects of the program are also important. Throughout its long history, Social Security has had multiple goals—some related to redistributing income, others to offsetting lost earnings. In 2004, only about two-thirds of Social Security's beneficiaries were retired workers; the rest were disabled workers, survivors of deceased workers, and workers' spouses and minor children. Policymakers will need to decide whether the program's goals are still appropriate, and if so, how changes to Social Security would aid or hinder the achievement of those goals and affect various types of beneficiaries and taxpayers. Those decisions will also need to take into account the dramatic increase in the elderly population that is expected in coming decades.

My statement examines the prospects for Social Security from each of those three perspectives, in reverse order, beginning at the programmatic level.

THE OUTLOOK FOR THE SOCIAL SECURITY PROGRAM

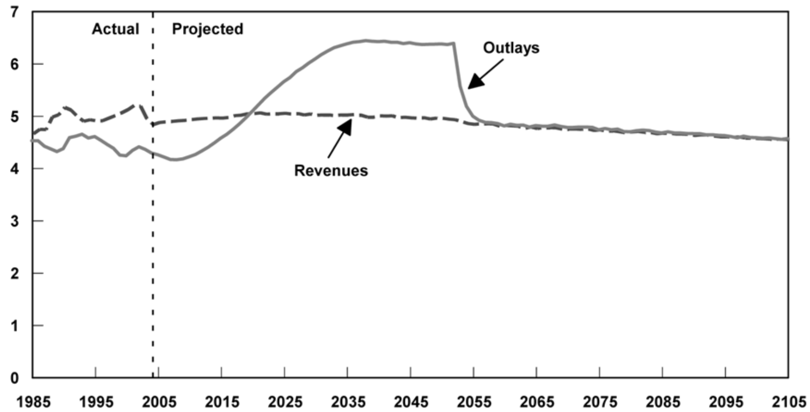
Although there is significant uncertainty involved in making numerical projections of the future of Social Security, the basic trajectory is widely accepted. The outlook for the Social Security program is generally the same regardless of whether one turns to the long-term projections of Social Security's trustees or to those of the Congressional Budget Office.

In 2008, the leading edge of the baby-boom generation will become eligible for early retirement benefits. Shortly thereafter, the annual Social Security surplus—the amount by which the program's dedicated revenues exceed benefits paid—will begin to diminish (see Figure 1). That trend will continue until about 2020, when Social Security's finances will reach a balance, with the revenues coming into the system from payroll taxes and taxes on benefits matching the benefit payments going out. Thereafter, outlays for benefits are projected to exceed the system's revenues. To pay full benefits, the Social Security system will eventually have to rely on interest on Government bonds held in its trust funds and ultimately on the re-

demption of those bonds. But where will the Treasury find the money to pay for the bonds? Will policymakers cut back other spending in the budget? Will they raise taxes? Or will they borrow more?

FIGURE 1.—SOCIAL SECURITY REVENUES AND OUTLAYS AS A SHARE OF GDP UNDER CURRENT LAW

(Percentage of GDP)



Source: Congressional Budget Office.

Note: Based on a simulation from CBO's long-term model using the Social Security trustees' 2004 intermediate demographic assumptions and CBO's January 2005 economic assumptions. Revenues include payroll taxes and income taxes on benefits but not interest credited to the Social Security trust funds; outlays include trust-fund-financed Social Security benefits and administrative costs. Under current law, outlays will begin to exceed revenues in 2020; starting in 2053, the program will no longer be able to pay the full amount of scheduled benefits.

In the absence of other changes, the redemption of bonds can continue until the trust funds are exhausted. In the Social Security trustees' projections, that happens in 2042; in CBO's projections, it occurs about a decade later, largely because CBO projects higher real (inflation-adjusted) interest rates and slightly lower benefits for men than the trustees do. Once the trust funds are exhausted, the program will no longer have the legal authority to pay full benefits. As a result, it will have to reduce payments to beneficiaries to match the amount of revenue coming into the system each year. Although there is some uncertainty about the size of that reduction, benefits would probably have to be cut by 20 percent to 30 percent to match the system's available revenue.

The key message from those numbers is that some form of the program is, in fact, sustainable for the indefinite future. With benefits reduced annually to match available revenue (as they will be under current law when the trust funds run out), the program can be continued or sustained forever. Of course, many people may not consider a sudden cut in benefits of 20 percent to 30 percent to be desirable policy. In addition, the budgetary demands of bridging the gap between outlays and revenues in the years before that cut may prove onerous. But the program is sustainable from a financing perspective.

What is not sustainable is continuing to provide the present level of scheduled benefits—those based on the benefit formulas that exist today—given the present financing. Under current formulas, outlays for scheduled benefits are projected to exceed available revenues forever after about 2020 (see Figure 2). That gap cannot be sustained without continual—and substantial—injections of funds from the rest of the budget.

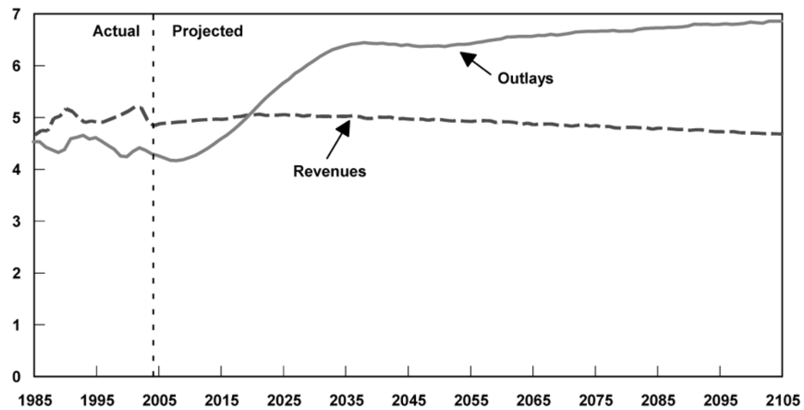
THE IMPACT OF SOCIAL SECURITY ON THE FEDERAL BUDGET

I would like to make three points about Social Security in the larger context of the total budget. First, Social Security will soon begin to create problems for the rest of the budget. Right now, Social Security surpluses are still growing and contributing increasing amounts to the rest of the budget. But as explained above, those surpluses will begin to shrink shortly after 2008, when the baby boomers start to become eligible for early retirement benefits. As the rest of the budget receives declining amounts of funding from Social Security, the Government will face a period of increasing budgetary stringency. By about 2020, Social Security will no longer be contributing any surpluses to the total budget, and after that, it will be

drawing funds from the rest of the budget to make up the difference between the benefits promised and payable under current law and the system's revenues. Policymakers will have only three ways to make up for the declining Social Security surpluses and emerging Social Security deficits: reduce spending, raise taxes, or borrow more.

FIGURE 2.—SOCIAL SECURITY REVENUES AND OUTLAYS AS A SHARE OF GDP WITH SCHEDULED BENEFITS EXTENDED

(Percentage of GDP)



Source: Congressional Budget Office.

Note: Based on a simulation from CBO's long-term model using the Social Security trustees' 2004 intermediate demographic assumptions and CBO's January 2005 economic assumptions. Revenues include payroll taxes and income taxes on benefits but not interest credited to the Social Security trust funds; outlays include Social Security benefits and administrative costs. In this simulation, currently scheduled benefits are assumed to be paid in full after 2053 using funds from outside the Social Security system.

CBO's projections offer some guidance about the potential impact of those developments on the budget. By CBO's calculations, the Social Security surplus (excluding interest) will reach about $100 billion in 2007; but by 2025, that surplus is projected to become a deficit of roughly $100 billion (in 2005 dollars). That $200 billion swing will create significant challenges for the budget as a whole.

Second, the demand on the budget from Social Security will take place simultaneously with—but be eclipsed by—the demand generated by Medicare and Medicaid. Currently, outlays for Social Security benefits equal about 4 percent of GDP, as does Federal spending on Medicare and Medicaid. But whereas Social Security outlays are projected to grow to almost 6.5 percent of GDP by 2050, spending on the two health programs is expected to grow substantially more. Over the past few decades, excess growth in health care costs—the extent to which per-beneficiary costs increase faster than per capita GDP—has been about 2.5 percent annually. If one assumes a fairly dramatic shift to a slower increase in health care costs—that excess cost growth will decline to less than half of its historical rate Federal spending on Medicare and Medicaid will still roughly triple by 2050, to 12 percent of GDP. The clear message is that although Social Security will place demands on the Federal budget, those demands will coincide with much greater demands from Medicare and Medicaid.

Third, a key distinction exists between the programmatic perspective and the budgetary perspective in analyzing policy changes. From a programmatic standpoint, the 75-year actuarial imbalance in the Social Security system (the present value of expected outlays over 75 years minus the present value of expected revenues over that period) equals 1.04 percent of the present value of Social Security's taxable payroll over those years, CBO estimates. That number suggests that, leaving aside economic feedbacks on the budget, immediately and permanently raising the payroll tax rate by about 1 percentage point or reducing initial benefits for newly entitled beneficiaries by 9 percent would address the 75-year imbalance in the system.

From a budgetary perspective, however, annual benefits would continue to exceed revenues by a large margin after 2025 under either policy change (see Figure 3). Thus, neither policy would provide a permanent solution for the system's financing. Either policy could fix that financing for the next 75 years, but only if the projected

cash-flow deficits shown in Figure 3 were offset elsewhere in the Federal budget. In principle, lower net interest payments on Federal debt held by the public could provide that offset. But such a policy change would fix Social Security over the next 75 years only if the rest of the budget was not altered.

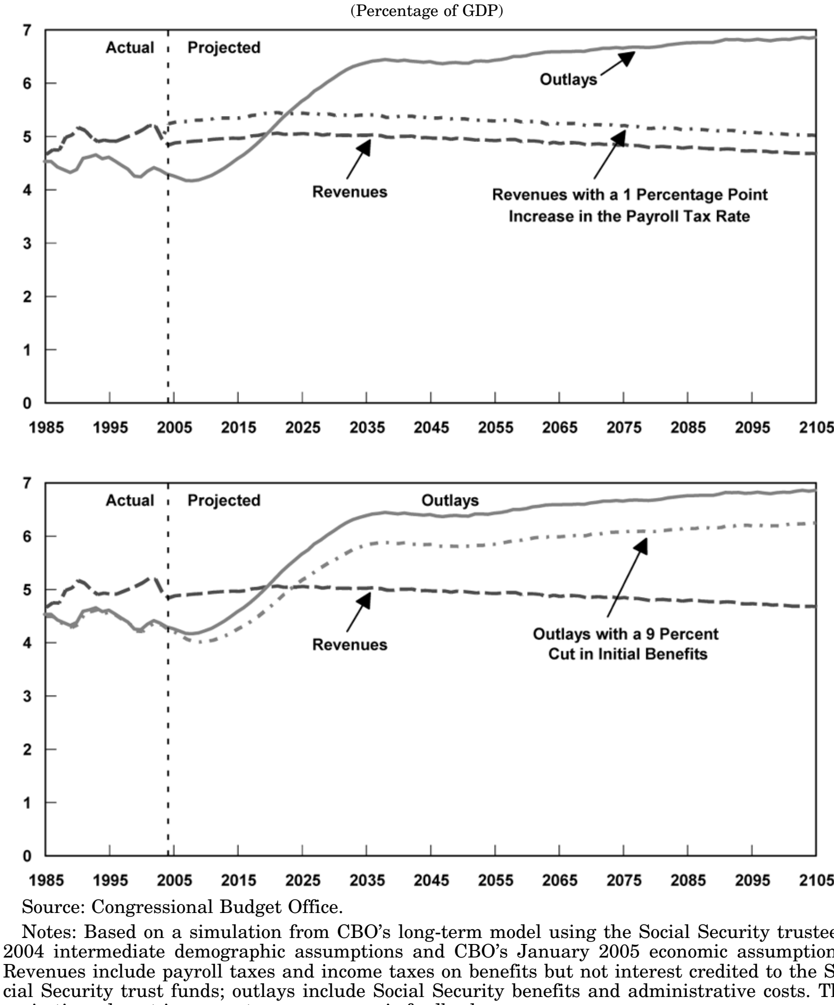
SOCIAL SECURITY AND THE ECONOMY

Although looking at the overall budgetary context is important, Social Security and its possible reform also carry significant implications for the economy and economic policy.

One of the major achievements of reform could be to resolve uncertainty about the future of the program. Uncertainty is an economic cost in its most fundamental form, and in the current context, there is uncertainty about the future of Social Security, its configuration, and who will be affected. The sooner that uncertainty is resolved or reduced, the better served will be current and future beneficiaries, who must make various decisions about their retirement (from how much they should save to when they will be able to stop working).

FIGURE 3.—SOCIAL SECURITY REVENUES AND OUTLAYS AS A SHARE OF GDP UNDER VARIOUS POLICY OPTIONS

(Percentage of GDP)



Source: Congressional Budget Office.

Notes: Based on a simulation from CBO's long-term model using the Social Security trustees' 2004 intermediate demographic assumptions and CBO's January 2005 economic assumptions. Revenues include payroll taxes and income taxes on benefits but not interest credited to the Social Security trust funds; outlays include Social Security benefits and administrative costs. The projections do not incorporate macroeconomic feedbacks.

Under current law, annual outlays will begin to exceed revenues in 2020; starting in 2053, the program will no longer be able to pay the full amount of scheduled benefits. Under either a 1 percentage point increase in the payroll tax rate or a 9 percent cut in initial benefits, outlays will exceed revenues by 2025, and scheduled benefits will not be able to be paid starting in 2083.

A key uncertainty stems from a central policy question: to what extent should the Social Security program in the 21st century resemble the program in the 20th century? There are two separate aspects to consider: insurance and financing.

In terms of insurance, the major issue is finding the appropriate balance between social responsibility and individual responsibility. On one side, some people argue that the nation needs a program of universal social insurance that allows for the redistribution of resources among individuals and provides a hedge against such adverse outcomes as poor health, unemployment, low wages, or simply bad luck. On the other side, some people argue that it would be better to have a retirement system that relied more on individuals (which proponents view as desirable in itself) and included provisions that strengthened incentives for individuals to work and save.

In terms of financing, the major issue is striking the appropriate balance between prefunding retirement (with each generation saving for its own retirement) and employing a traditional pay-as-you-go method of financing (in which assets are not accumulated, but instead current revenues are used to finance benefit payments to retirees). Prefunding retirement benefits has the potential to increase the nation's capital stock, boost productivity, and raise GDP in the long run. However, prefunding requires some people to consume less or work more than they would otherwise during a transitional period.

Although prefunding could be carried out either by having individuals save more or by having the Government save more (through smaller budget deficits or larger budget surpluses), analysts disagree about the extent to which the Government could actually prefund retirement benefits, for several reasons. The experience of recent years, for instance, raises questions about the likelihood that the Government would be able to maintain budget surpluses for long periods of time.

Regardless of one's views about those issues, any approach to Social Security will have to confront the new demographic situation—low fertility rates; declining mortality rates; and changing patterns of marriage, divorce, participation in the labor force, and immigration—as well as a host of other factors that are very different now than they were in the past. Reconfiguring Social Security to reflect those new realities, and better insulating the system from unexpected demographic or economic changes, will be major challenges for policymakers.

Chairman NUSSLE. Thank you, Mr. Director. As I announced previously, I am going to go to members who have not had an opportunity to question the first panel to begin with. So Mr. Baird is recognized for 5 minutes.

Mr. BAIRD. I thank the Chairman. I thank the gentleman.

I would say at the outset that our experience, my experience on this committee, these two individuals have given us the most forthright, balanced, and objective information that we are privileged to receive. And I am grateful for their presentations, not only today, but previously.

I want to just address a few quick items that were sort of left over from the last speaker. First of all, one of my good colleagues Mr. Portman, suggested that it is the Congress that has been spending the Social Security trust funds. I would point to page 363 of the President's budget offered to us by OMB, and would note that in 2005, the President proposes to spend $162 billion of the Social Security trust fund; in 2006, 173 billion; in 2007, 197 billion, on up to a total of 256 billion in 2010 alone. In 5 years, it amounts to over a trillion dollars. In 10 years, I suspect it would be $2 trillion of expenditures not proposed by the Congress but proposed by the administration. Just to clear that.

Secondly, the Treasury Secretary said that he thought it was appropriate to characterize Social Security as approaching bankruptcy. My assumption there is he seeming to be suggesting that

if current demands exceed current revenues into a system, we are thereby bankrupt. If that were to apply to the Federal budget overall, do current—and I will ask the two gentlemen as experts in this area. Do current revenues for the U.S. Government exceed or fall short of current expenditures?

Mr. WALKER. They fall short. And if I can address the issue of insolvency versus bankruptcy. One of the things I find in Washington is that sometimes you have to go back to Webster's to look for the definition. The definition of bankruptcy is utter failure or impoverishment. The definition of insolvency is unable to pay debts as they fall due.

I would respectfully suggest, for 2042, the program would be insolvent under that definition but not bankrupt.

Mr. BAIRD. That is a very helpful clarification, and I appreciate it and share the opinion. I would be remiss if I didn't just make a marker here today about one of our concerns in the northwest about the President's proposed budget. I will not ask these gentlemen necessarily to comment on it, but it needs to be for the record. The proposed budget seems to depend for an increased source of revenues on gradually shifting what are currently cost based power rates in four power marketing areas of the country to market-based power rates, effectively leveling an increased taxation in the form of increased power rates on those four regions of the country. I personally am profoundly opposed to that. It goes against a proud tradition of this Government of supporting market-based rates in the public power supply systems, and would just like to put that down. And I believe it would have a profoundly negative impact if you increase power rates by up to 20 to 50 percent in those regions. I think it would be tantamount to a gross taxation on those consumers, and would be opposed to that.

Let me ask a question that maybe you can help me address. Would you think it is good advice for a hypothetical family alluded to by Mr. Wicker and others to advise your children to go out and borrow money in order that they can invest it?

Mr. HOLTZ-EAKIN. At the individual level, the issue is the degree to which you have a comfort for risk. You can borrow and invest. That is known as leverage. It offers you the potential for higher rates of return and it carries with it greater risk. And in the United States' financial markets, individuals have the ability to tailor their investment strategy to the kind of risk that they are comfortable taking.

Mr. BAIRD. Would it be a good——

Mr. HOLTZ-EAKIN. Truthfully, that is not the kind of advice you will ever get me to give personally or otherwise. I am much too much of a coward. But I would give them exactly those options and send them on their way.

Mr. BAIRD. So in general, though, it would seem to me that to some extent banks must set their interest rates proportionate to what one might receive were they to invest the money in another way, and they must somewhere make a calculation that we think overall, again bearing in mind risk, that the amount of risk you would obtain from investing your borrowed money doesn't seem to me that the percentages would play out. In other words, would you say son or daughter go out and borrow a bunch of money from the

bank and then put it in the stock market because that will get you more money for sure than the interest rates you will pay on the loan?

Mr. WALKER. Well, first, as you know, interest rates vary based upon the type of borrowing. Credit card interest rates are very, very high; interest rates for mortgages or home equity loans are a lot less. And so, therefore, one would have to determine with what degree of confidence that they have that they are going to end up gaining a net positive return from that leverage, understanding that there is nothing guaranteed.

Mr. BAIRD. That is a good summary.

The final question, and I don't think you have time necessarily to answer it. But I haven't heard anyone really talk about this and I have some questions. What would be the impact on the value of extent shares in the stock market of gradual or sudden influx of new purchasers of stocks under this type of scenario? In other words, we tend to talk about what happens to the Federal budget deficit vis-a-vis this, but wouldn't there be some substantial impact on the value of stocks in the market?

Mr. HOLTZ-EAKIN. The benchmark valuation will be driven by the underlying fundamentals in each company. And shares are worth no more than the future profits to which they give you claim. It could be the case that, given shifts in portfolios of this type you would see some transitory revaluation, but it is hard to imagine you would get a persistent revaluation of the same profits.

Mr. BAIRD. Thank you. I thank the gentleman and I thank the Chair.

Chairman NUSSLE. Mr. Walker, I have before me the Webster's No. 2 New College Dictionary. I would just like to read you a definition of the word "crisis:" A crucial or decisive point or situation.

I think we are probably, at least according to Mr. Webster, at a crisis point if in fact we have got to make a decision now as you have counseled us. Problem is defined as, a question or situation that presents doubt or perplexity. I would suggest to you that politicians have problems with Social Security, and I would suggest that Social Security itself is in a crisis, according to these definitions. I am just having fun with you.

Mr. Jefferson for 5 minutes.

Mr. JEFFERSON. Thank you, Mr. Chairman. This is the first time I will have a chance to inquire about anything as a member of the Budget Committee, so I am pleased to have a chance to participate in these most important hearings. I am sorry that Mr. Portman isn't here, because my line of inquiry has to do with his assertions about the value of private accounts. He said, if I can remember correctly, that one might expect a 5 percent return on private accounts as against a 1.8 percent or so percent return on that is now yielded by Social Security investments. But I note, however, that under the President's proposal, as I am given to understand it, CBO projects a 3.3 percent return on private accounts; the Social Security Administration projects a 4.6 percent return; but in each case they also anticipate a crawlback of 3 percent.

And I just want to see if you agree with me that if the CBO bears out to be correct at 3.3, with a clawback of 3 percent, then there is virtually nothing from the investment that would be yield-

ed from private accounts. And if SSA is right and the return is 4.6 percent with a clawback of 3 percent, then there is actually a 1.6 percent return. Am I correct in my analysis of that?

Mr. HOLTZ-EAKIN. If I could, let me say a few words about the different rates of return that are floating around, because I think there is a fair amount of confusion, particularly about the work that we have done. One rate of return is the rate of return that is possible in a sustainable pay-as-you-go Social Security system. That rate of return with current beneficiaries being paid by current taxes, the rate of return is only the rise in the payroll tax base. That is the only way you can get a rate of return in that kind of a system. In our projections, that would be a number that would look like one and a half, 2 percent real increase. We don't have a sustainable Social Security system, so rates of return are quite likely to be lower than that in the future as taxes are raised or benefits are cut.

The second rate of return would be the rate of return possible in a prefunded system. One could imagine paying for one's own retirement. Instead of paying for current retirees, you pay for your own retirement by putting funds away. There, you could get, given historical rates of return, 3.3 percent after inflation simply by putting it in U.S. Treasuries.

You could also then get a higher rate of return if you chose to take more risk. In our estimates, we assume the return on corporate equities is 6.8 percent, inflation adjusted, and corporate bonds would be in between. You could pick a portfolio and get a higher rate of return. Our rates of return are no different than anyone else's. Although they differ numerically, we acknowledge the higher rate of return——

Mr. JEFFERSON. You have chosen the 3.3 percent figure even though you could check the figures and have chosen some other ones.

Mr. HOLTZ-EAKIN. Let me finish. Those are all the rates of return that we use, and so those are consistent with history, they are consistent with the economics that we have.

The final question is, what would be the valuation now of a transaction that gave me the access to, say, corporate equity? It has a higher return historically, and we don't dispute that it comes with a higher risk. As Mr. Baird's question suggested, different people value that risk return trade-off differently. What we have done is examined the average as reflected in U.S. financial markets and note that in the U.S. financial markets individuals simultaneously hold Treasuries for the 3.3 return and equities that get 6.8 in the presence of risk. They therefore right now view their futures as valued equivalently. And that is the nature of our analysis. It is not quite the same thing as saying the individual account will get 3.3 percent.

Mr. ORSZAG. We should be building accounts where they belong and shoring up the traditional program as a core tier of financial security. Thank you very much.

Mr. JEFFERSON. I understand.

Mr. HOLTZ-EAKIN. It was a long answer, I apologize.

Mr. JEFFERSON. Right.

Mr. HOLTZ-EAKIN. There are many, many different returns there.

Mr. JEFFERSON. At the end of the day, though, I am using the figure 3.3 percent, because that is—after all that summarizing, we ended up with a number that we used as a—I mean, the report that I have is that CBO's suggested rate of return, inflation adjusted, such and such.

But my point is, there is a clawback in this provision, isn't there, of 3 percent? So whatever we do, whatever number we arrive at, we have taken away 3 percent which goes back to the Government. The individual person gets what the excess is, correct?

Mr. HOLTZ-EAKIN. Correct.

Mr. JEFFERSON. So it would be incorrect to say that there is a 5 percent return, any percent return is pure investment that doesn't involve the clawback, that would be correct wouldn't it?

Mr. HOLTZ-EAKIN. One could evaluate the investment or, as David suggested, the whole package. If the package has investment plus diminished regular benefit, it is the net effect that would matter.

Mr. JEFFERSON. Last question, if I could squeeze it in here. What would be the value of one's nest egg now that would yield $850, or something like the average return, the average Social Security check today that one gets every month? What would be the size of a nest egg that one would need to generate that sort of monthly income?

Mr. HOLTZ-EAKIN. I am sure that is a question for Dave. I will be happy to provide——

Mr. WALKER. We can find out. Mr. Jefferson, I think there is one thing that you and all members need to keep in mind, not all promised Social Security benefits have been funded.

If you did nothing, then if you are 30 years of age or younger, your benefits are going to get cut by 27 percent plus, all at once, for your entire life. If you are over 30, your benefit is going to get cut by 27 plus percent, all at once, for the remaining portion of your life.

We believe it is important, when you analyze proposals, you have benchmarks based on both promised benefits and funded benefits, because it is not fair to assume that all the current promised benefits are funded.

There are going to have to be changes, with or without individual accounts, to make this program solvent, sustainable, and secure for future generations.

Mr. JEFFERSON. On the nest egg, can someone answer that—what size would the nest egg have to be to generate——

Mr. WALKER. I would be happy to try to provide something for the record. We could do some math on it and be happy to try to give you something.

MR. WALKER'S RESPONSE TO CONGRESSMAN JEFFERSON'S QUERY ABOUT NEST EGG SIZE

One estimate of the nest egg required today to yield a monthly benefit is the present value of one's lifetime Social Security benefits. Based on CBO's *Updated Long-Term Projections for Social Security* (March 2005), the initial median monthly

Social Security benefit for a peson aged 65 today[1] is about $1,140. CBO estimates the lifetime scheduled benefits for that person to total about $127,000 (in present value 2004 dollars discounted at the Treasury rate.[2]

However, as time goes on and both wages and Social Security benefits increase, the nest egg required to provide median scheduled Social Security benefits would increase. For example, the initial median monthly Social Security benefit for a perwson born in 2000 is about $2,083. CBO estimates the lifetime scheduled benefits for that person to total about $265,700 (in present value 2004 dollars discounted at the Treasury rate).

As I noted at my testimony, scheduled Social Security benefits are not funded. If you did nothing, according to CBO's estimates a person born in 2000 would only receive 71 percent of scheduled benefits over his lifetime.

Chairman NUSSLE. Mr. Lungren for 5 minutes.

Mr. LUNGREN. Thank you, Mr. Chairman, and thank you for appearing. I am sorry I missed your live comments. I was over on the floor on the immigration bill.

From the exchange I just heard, it reminds me of Larry Gatlin and the Gatlin Brothers, and the lyrics of the song they sang a number of years ago: "all the gold in California is in a bank in Beverly Hills in someone else's name." There are a lot of people who assume that there is an account sitting there at the Department of Treasury with their name on it that is fully funded.

I guess one of the things we have to do is to try to explain to people what the reality is. I think as you pointed out, we have promised benefits, but we haven't funded those benefits. The question is, how do we fund it, and do we do something to essentially change in part the nature of Social Security, so it is not only funded, but that we don't run into these problems in the future?

I guess I would address this question to both of you to see your perspectives on that.

Secretary Snow has said that each year that we don't do something it gets worse. They have put a number on it, $600 billion a year.

Can you give me your observations on the accuracy of that comment and how we come to that conclusion?

Mr. HOLTZ-EAKIN. My observation would be—I am not the source of the number, I don't know how it was calculated, but it has the feel of one of these actuarial numbers that looks out over the future horizon.

As I noted in the remarks that you missed, ultimately those actuarial calculations carry with them some budgetary implications to make them whole. So to the extent that you want to go that way is a matter of preference. I think it is more useful to look at the cash-flow demands in the context of the other demands that this Congress will face, and that those happen very quickly, the surpluses begin to diminish. They are consequential aspects of the Federal budget, and I think that is a metric of how soon things happen that will be useful and reveal the trade-offs.

Mr. LUNGREN. Let me ask it very simply, and that is, is it true that every year that we postpone doing something to change the system as it is now makes the system worse?

Mr. WALKER. That is true. The reason it is true is because of demographics, because every year you drop a positive year—last year

[1] This estimate reflects the benefit for a retired worker; it does not reflect disability or survivor benefits.

[2] All values are net of income taxes paid on benefits.

we had $151 billion surplus, and you add an increasingly bad year because of demographic trends. So it is true that it gets worse with the passage of time.

Mr. HOLTZ-EAKIN. Yes.

Mr. LUNGREN. A question that I have for you, and this has been a subject that often has been talked about, I guess; it is option 2, or the Penny option, or whatever we call it, the Tim Penny option—which is to change the indexing from, as it is now, wage increases to price increases.

There is some graph that the other side keeps putting up that shows you are going to diminish the benefits, and they do it as a percentage of replacement income, I believe.

My question is a little different. Maybe I am wrong on this. I would like both of your observations.

If we go to a price indexing, is it not in the nature of price indexing that you are preserving the purchasing power for the individual? In other words, there is purchasing power equity as opposed to what appears that they are suggesting. If you have wage indexing, you actually have more purchasing power 10 years down the line as opposed to price indexed?

Mr. HOLTZ-EAKIN. Can we pull up slide 14?

Slide 14 is an illustrative example of exactly the question that you asked, and it shows what would happen to the median person in the population.

Go back one, please. Thank you.

Under current law, black lines, price indexing, blue lines, current law—and these are for people, going from left to right, older to younger. The right-hand are those born in 2000. So, under current law, you will see that as we move to the right, ultimately benefits get cut due to trust fund exhaustion, and then begin to rise after that.

The pricing indexing just sets the purchasing power roughly equal. You see the blue lines are the same for all cohorts going forward. That is the nature of that kind of a proposal.

Mr. LUNGREN. So price indexing would allow you to have the same purchasing power year after year after year.

Mr. HOLTZ-EAKIN. Right. That is the blue lines I am looking at.

Mr. LUNGREN. Right. But I am just trying to get that clarified, because when you go to this question of salary replacement percentage, or whatever it was they were using there, it shows—it gives a tremendous diminishing line. If what we are trying to do is preserve a system that allows you to purchase what you can now on into the future with price indexing, that means something different to me than I had thought.

Mr. WALKER. I think I can help you. I would say that the difference if you do price indexing, you are preserving purchasing power based on today's standard of living.

Mr. LUNGREN. Correct.

Mr. WALKER. OK. If you do wage indexing, you are preserving a relative standard of living for tomorrow's standard of living, so that is the difference.

Chairman NUSSLE. Mr. Case for 5 minutes.

Mr. CASE. Thank you, Mr. Chairman.

Gentlemen, Social Security is the big picture, and so are a number of the other issues. I am going to go a step above that and talk about something that I raised with

Mr. Bolten yesterday: debt over the long term.

What I want to engage you in is getting straight in my mind where we stand with the debt of this country. Under the budget as submitted by the President, as I understand it, the total debt of our country today is roughly $7.6 trillion; is that about right, a little bit above the $7.3 trillion it was a few months ago?

Mr. HOLTZ-EAKIN. That presumably includes debt held in trust funds?

Mr. CASE. Yes, all debt; debt subject to the debt ceiling that we have voted on a number of times, total debt. The President's budget projection, which only goes out 5 years, projects the debt is going to go to $11.1 trillion in 5 years. Now, I just want to be sure that I have got straight what I am being told by everybody.

That is that when we talk about that debt, when we talk about the President saying he wants to halve the budget deficit within 5 years, we are still talking about the accumulation of greater debt every single year; is that right? I mean we are not halving the budget, but halving the deficit. We have still got a deficit of somewhere between $200 and $300 billion a year. That is adding up, right?

Mr. HOLTZ-EAKIN. Yes.

Mr. CASE. Fueling a higher debt. That does not include, as I understand, any additional spending, because that is what it is. Spending for either outright expenditures having to do with the Iraq-Afghanistan war or whatever costs there are, short term, long term, permanent or temporary, of converting Social Security or to repair the alternative minimum tax or increased debt service for that matter. Is that your understanding?

Mr. HOLTZ-EAKIN. We will do a complete analysis. As you know, my understanding is there is recognition in there—the potential $80 billion supplemental for 2005 but nothing past that in Iraq.

Mr. CASE. Now, if we added up all of those assumptions, do you have any quarrel with the estimate by my ranking member that the total amount would be somewhere in the range of $2 trillion additional to that debt?

Mr. HOLTZ-EAKIN. I am always loath to certify numbers on the fly, but we have done calculations similar to that in our January budget outlook, and I would be happy to work with you on that if you want me.

Mr. CASE. Is that in the range?

Mr. HOLTZ-EAKIN. Sounds about right, but I don't know the pieces.

Mr. CASE. Now, let me cover the next 5 years. I have been told, and I believe, that it gets a lot worse a lot faster after that first 5 years, unless we do something now or next year or sometime in the near future. Does that generically ring true to you?

Mr. HOLTZ-EAKIN. Oh, yes; generically these are the good times. The outyears with Medicare, Medicaid, Social Security, rising costs in the budget, are all far more daunting than what we are seeing right now.

Mr. CASE. For example, that debt number of $11.1 trillion does not include the potential extension of tax cuts that under current law sunset prior to the end of that budget cycle, is that right?

Mr. HOLTZ-EAKIN. That is true. I would add that in our 2003 long-term budget outlook, we showed paths going out to 2050 for the budget, with and without the tax cuts, and alternative scenarios.

The troubling fact is it is very unlikely that current law, fiscal policy is sustainable with or without the tax cuts over the long term, and that to attempt to maintain the levels of spending committed at the moment would be quite damaging.

Mr. CASE. I guess what I am trying to get at is, OK, we have got the President somehow saying that somehow it is cool and good, and it is OK, manageable, sustainable, that we see our total Federal debt run up 60 percent in the next 5 years, an increase to 60 percent, but it is actually a lot worse than that. We can add on $2 trillion more debt unless we have a wild increase in income somehow or a $2 trillion reduction in offsetting expenses somewhere else.

We also have the potential at least of a much greater deficit arising, and debt, if we extend the reduction in revenue arising from the tax cut extension, right?

Mr. WALKER. That is right.

The bottom line is that we face large and growing structural deficits due primarily to known demographic trends and rising health care costs; and it is not just on the revenue side, it is also on the spending side.

There are a number of spending items—for example, the new Medicare prescription drug bill is going to cost a tremendous amount of money. The related costs will escalate beyond the 5-year horizon.

To help let us take last year. Last year the unified budget had a deficit of $412 billion, so the Government had to borrow that. But the Government also borrowed the $151 billion Social Security surplus and the $4 billion in surpluses elsewhere.

So the "on-budget," largely non-Social Security budget deficit was much bigger, and that is one reason why you have a difference between debt held by the public, trust fund debt, and total debt. When we have trust fund surpluses the Government spends it all on operating expenses and replaces the excess cash with IOUs. That affects the total number for the debt ceiling, but it is not shown as a liability on the financial statements of the U.S. Government.

Mr. CASE. I am afraid my time has expired. I was just getting going. Thank you.

Chairman NUSSLE. Let me take a quick round, and then I understand that Gen. Walker has to get to another hearing.

My very good friend, Mr. Baird, earlier was talking about this notion that was brought up before about the difference between borrowing to spend and borrowing to save. I was trying to think, because when I first heard this by the administration, I have to say, similar to my friend, I thought, well, wait a minute, borrowing is borrowing, you know. There really—is there really a difference?

Then I got to thinking, now, wait a minute. I do it all the time—or, not all the time—I did it once when I bought my house. I mean, I borrowed to invest in something I couldn't afford right off the bat in cash. So we do borrow.

My guess is my friend from Washington has probably a similar situation. He can't afford his house either. None of us can. But we borrow to save and invest in that home.

We do the same thing for our kids, interestingly enough. I can't pay for my son to go to the college I went to. So I borrow, and I am going to make him, you know, work as well to pay for his fair share.

The point is, is that I am willing to borrow to invest in something that is going to come back with a—maybe not a financial rate of return for me, but something I know is a pretty strong investment, or at least I hope it is. If it isn't, I am going to—like I said yesterday—build a woodshed.

The same is true for business, and small business. I was reading here in an article in "Entrepreneur Magazine" recently, that in order to start your own Subway—not subway system but the new franchise, which is evidently one of the hottest-growing franchises in the country—you need, I think, $175,000. But it is a pretty good investment right now, with the low carb and diets and all that kind of stuff, to go out and sink and borrow and invest in a business that you want to get a rate of return. So borrowing for operating, as you indicated, is different than borrowing for savings or borrowing for an investment vehicle.

So I understand that there are—you know, to borrow to go to Vegas, that is not interesting to me—and it certainly wouldn't be—according to what Mr. Holtz-Eakin just said, borrowing possibly to sink it into a security might also be a little bit riskier than I want to go. But businesses do provide that kind of function all the time.

We do have a personal connection with this notion of borrowing in order to invest. So I see a difference between borrowing for spending in the operating budget versus borrowing for savings or investment. I just want to put that out there.

The expected thing was this whole notion of rate of return. This is going to be a big challenge, because depending what number we pick and how we come up with that, it is going to be a huge debate, because some are going to say, wait a minute. Some are first of all going to say, this isn't the way to do it.

Let us assume for a moment that they are not part of this discussion. Let us assume that it is a matter of do you take the high or the medium or the low. What advice would you have with regard to rate of return and how we go through the discussion of making this determination? You are going to give us advice, the actuaries are going to give us advice, the markets are going to give us advice, our constituents are certainly going to give us advice. What process would you suggest we go through in determining the rate of return for this vehicle that we want to set up, which is, as I said, it is similar to investing in our kids' education or investing in our home; which is borrowing some money, knowing full well that you are taking some risk, but it is a pretty good investment. People do it all the time. It is the No. 1 way people save for their retirement is in their home.

So how would you help us through this process of going through this issue of rate of return?

Mr. HOLTZ-EAKIN. I would offer a couple of observations. The first is that you do not place great emphasis on differences between the CBO and SSA. We believe the long-term real return to Treasury is 3.3. They say it is 3 percent—that is, given the standards of economic science over these durations, the same estimate.

We have corporate equities at 6.8 percent. Their estimate is very similar. So I think qualitatively these are the same kinds of perceived returns to different investment vehicles that have different levels of risk, be they Treasuries, the least risky; corporate bonds, a bit more risky. Corporate equity is the most risky out of the broad sets of choices. So that is number one.

Number two, I don't think that there is any great disagreement about the historic returns, as I said, or, as a result, the possible outcomes that one could get if you held a portfolio over 50 years, again and again and again. On average, we think the corporate equities will turn out to be 6.8 percent. That is what people historically have gotten and would likely continue to receive in the absence of large changes in the economy.

The real tough question is to make sure that people understand the difference between looking backward and, right now, looking forward in doing the valuation exercise that financial markets do every day. Every day, financial markets and the participants look at return opportunities and their risk, and they value those opportunities. They evaluate them by putting their money in or selling them off because they decide that that the risk/return trade-off is unacceptable.

This Congress and participants in this debate are making that same valuation decision. They are looking at potential risk and return—and we hope that we have displayed that to people in our analyses—and they can make a judgment as to whether it constitutes good public policy in the area of Social Security.

The CBO, in my final observation, simply follows what we think of as bread-and-butter budgetary practice in doing this. When we value things on the budget, we look to the market. We ask what would it cost to buy these supplies for the military? We ask what would it cost to provide this aid to schools and education?

In this instance, we ask what is the market's valuation of a dollar put out there for investments in the financial market, and markets equate $1 for Treasury and $1 for equity in a very particular way, which reflects the average tolerance for risk out there in American financial markets, and that is what we are going to use to do that valuation exercise.

It is an extraordinarily difficult area. I anticipate that it will continue to be an area of great confusion. I once made a vow I would not talk about modern finance in public, and I have violated that vow several times now.

I would be happy to work with the committee as we work through the understanding of the different risks and returns that are present in the current system and in any reforms.

Chairman NUSSLE. Mr. Walker.

Mr. WALKER. Mr. Chairman, I would say two things. One, I think you need to consider input from a number of sources in analyzing

what is an appropriate assumption to make with regard to rates of return. But I think you ought to give heavier weight to professional, objective, and credible organizations that do not have a vested interest in the outcome, like CBO, GAO and the Social Security actuaries.

Secondly, I think you have to also understand to what extent is the rate of return relevant. We have to keep in mind this is a social insurance system.

Rate of return is something that is interesting for an individual to understand how well they are doing, and it may be relevant in determining what type of offset there might be in order to be able to pay for the individual accounts. If there is a standard offset, for example, the example that Mr. Jefferson gave, then the rate of return is only relevant for purposes of determining what kind of deal the individual is going to get.

On the other hand, if there is not a standard offset, it could be relevant for determining what the—you know, what other costs to the Government might be.

Thank you.

Chairman NUSSLE. Thank you.

I understand, Mr. Walker, you need to leave for your——

Mr. WALKER. I need to leave in about 10 minutes,

Mr. Chairman, if I that is OK. I wanted to make sure——

Chairman NUSSLE. OK.

Then Mr. Spratt is recognized for 5 minutes.

Mr. SPRATT. Has everybody had a chance?

Chairman NUSSLE. On this panel, as I understand it, yes. What we are doing, we went around one time, now we are going to go around again.

So, Mr. Spratt, quickly.

Mr. SPRATT. First of all, with respect to the time frame for talking about solvency, 75 years is the common standard—the actuaries have established that—but Treasury and others sometimes use an infinite timeframe. The dollar difference is significant, it is \$3.7 trillion for the 75-year-period. It is over \$10 trillion for the infinite time period.

Which is a better index?

Mr. WALKER. I personally use 75 years, but I think the important point is this: irrespective of what period of time you use, you want to try to make sure that whatever solution you come up with deals with the problem, hopefully indefinitely. In 1983, they solved the problem, but they knew on day one that they had only solved it for at most 75 years because of demographics. So whichever period you use, try to make sure you are achieving a solution that doesn't automatically require you to come back and deal with it again.

Mr. HOLTZ-EAKIN. I don't like either. I prefer to look at these in the cash-flow context that we displayed in the charts at the outset. If one is realistic about the fact that this will take place in the context of a larger set of budgetary demands, I think it is important to note not just the number, which is divorced of timing, but how fast things get big, and which things hit first. The demographics drive Social Security, it is true.

The demographics also drive Medicare and Medicaid, but the health care costs also drive them so they get bigger and they get

bigger quicker. Using these present-value horizons divorces the analysis of timing and makes it hard to examine budgetary trade-offs.

For that reason, I would encourage you to think about the cash-flow futures, the qualitative information you get from the notion that the promised benefits lie above the dedicated revenues for as far as I can see. So you can pick a horizon and pick a number, but qualitatively the policy number is that cash-flow.

Mr. SPRATT. Well, given the problems we are projecting way into the future—longevity, fertility, productivity, and the factors that underlie that—isn't an infinite time frame terribly tenuous?

Mr. HOLTZ-EAKIN. The uncertainty increases as time goes out, which is a reason why we don't prefer it. Even if it arises at the CBO, we try to display the uncertainties because we think they are important. But mechanically, we calculate year by year numbers, so infinity is a problematic concept for us.

I think you should look at this not in terms of a right-or-wrong issue, but a risk-management issue, and know that making decisions about longer horizons involves greater uncertainty.

Mr. SPRATT. We had an exchange with the Secretary about the likely cost additions to the deficit and to the debt to move to, say, partial privatization.

Our back-of-the-envelope analysis indicates that in the first 10 years of implementation, the costs would be $1.4 trillion. In the second 10 years, the cost would be $3.5 trillion. Therefore with 20 years, the first 20 years of implementation, the cost would be $4.9 trillion. And of course it wouldn't stop there, it would continue at least past the midpoint of the 21st century.

Do those numbers sound as if they are roughly in the ball park to you, number one?

Number two, if the Government has to borrow that kind of money, are there consequences for the Federal Government, for the economy?

Mr. HOLTZ-EAKIN. Let us just stipulate the numbers are right. We haven't had a chance to scrub them. I would say there are a couple of things that are important.

The first is that this is borrowing that will be put right into savings. So from a national saving perspective, this is a wash. That is the difference between a budgetary view of the world and a broader economic view of the world.

Number two, in any reform analysis, the borrowing for individual accounts is step two of a two-part process. Step one is what happens to the underlying program. Without knowing the answer of what happens to the underlying program, it is not possible to calculate the net borrowing with any real precision. Neither can you calculate the economically important impact, which is what will happen to net national saving, and, as a result, the ultimate growth in the economy. So to be honest——

Mr. SPRATT. You have to make behavioral assumptions amongst other things, don't you?

Mr. HOLTZ-EAKIN. You have to know the plan. Without knowing that, it is not possible to say with any great precision.

Mr. WALKER. Mr. Spratt, having individual accounts funded from the existing payroll tax revenue, even with other reforms, will ac-

celerate the negative cash flow, because obviously the other reforms are likely to save money in the outyears, whereas the individual accounts are going to cost money in the near-term years.

But to a certain extent it is a timing difference. Because if you do nothing and if you want to deliver on the promised benefits, it is only a matter of how much and when you will have to borrow.

The other thing is if we end up having to go to the markets to borrow more debt from the public rather than borrowing from ourselves—i.e., from the trust funds—then that could have an effect on interest rates, because obviously there is going to be more competition for capital. Now, whether or not it would, I don't know. I am not a Ph.D economist, but——

Mr. SPRATT. But this is going to occur in 2020, for example, as we begin to liquidate those trust fund bonds in a matter of ordinary course, the ones that have already accumulated, and the Social Security administrator has to go to the Treasury window, present their bonds for redemption. That is going to require that internally held debt be converted to externally held debt. So you have that burden in the market, several trillion dollars for that kind of conversion.

Then you load on top of it $3, $4, $5 trillion more, plus the debt we are accumulating in the operating budget of the United States. It seems to me that sooner or later we hit the wall. I mean, there is a limit beyond which we can go and borrow without convincing the world's markets that there is a high risk that we will try to inflate our way out of it, that this somehow disavows some of the debt.

Mr. HOLTZ-EAKIN. Let us do all three in order.

First, the operating or budget deficit. I won't repeat all the things I have said about what I view as the sustainability of our fiscal condition.

Step two, redemption of bonds in the trust fund. Absolutely, those bonds will be redeemed. They are backed by the full faith and credit of the Federal Government. The question is how they will be redeemed; if indeed they are redeemed by simply borrowing from the public, that will represent essentially de facto increases in the operating borrowing, and we will have the same consequences.

Step three, additional borrowing, which is immediately funneled into individual accounts. That, I think, is qualitatively different. I believe financial markets will be well equipped to see the difference. They will see additional Treasury borrowing; they will see a simultaneous increase in the demand for that same borrowing if individuals put Treasuries into their portfolios. If they don't, there will be a broadly defined increase in the demand for financial market investments.

Mr. SPRATT. Well, it may be perceived differently to some extent by the financial markets. But with respect to the Federal budget and how the debt affects its operation, it still has to be serviced, it still has to be paid. To the extent those things are honored, it displaces something else. It takes precedence. If anything, it is obligatory in a Federal budget that we have got to pay the interest, and we have got to pay the debt.

Mr. HOLTZ-EAKIN. I will be the last person to disagree with focusing on the budgetary consequences of Social Security reform. I mean, I think looking at the broad budget context is exactly right.

My point is simply that financial markets will be in a position to see both the additional borrowing and any additional investments. They won't have to speculate about it. It will happen at the same time with observable cash flows, and that will make it easier for them to discern the net demands that the Nation makes on their capital markets.

Mr. SPRATT. One final question to Dr. Holtz-Eakin. Can we expect your analysis of the President's budget early in March, the first week in March?

Mr. HOLTZ-EAKIN. You will have the numerical analysis in time to mark up the budget resolution. You will get the full-blown analysis with the words shortly thereafter.

Mr. SPRATT. One other question. Do you have enough data now to do a financial markup of the President's proposal?

Mr. HOLTZ-EAKIN. No.

Mr. SPRATT. Thank you.

Mr. PORTMAN [presiding]. Thank you, Mr. Spratt.

I missed my questions earlier, so I will take my questions now, and then we will go on to Mr. Cooper.

First of all, I appreciate your testimony today, as always. Both of you give us additional insights that are helpful. And we had an interesting discussion earlier, the Secretary of the Treasury, about so many of these issues.

The one I focused on, of course, was the fact that we have this trust fund that is sometimes described as being available for retirement benefits without paying, in other words, without having to either borrow more, tax more, or cut spending. And that is simply not the case, because we have spent it.

You talked about the personal accounts as being qualitatively different, Mr. Holtz-Eakin, and you focused on the fact that net national savings should be a wash, because you are taking funds in for investments.

Some of those investments, as you rightly state, will actually go directly into Treasury; others will go into equities; others will go into corporate bonds. And in a very regulated way, the President has laid out a program, you know, that is not outside of Social Security. It is very much regulated by the Government and within Social Security.

Can you talk a little about that aspect of it? In other words, when we are borrowing for whatever the number is—and Mr. Spratt has a number—it may be correct for personal accounts—aren't we both adding to our savings—and this is capital that will be available out there in the municipal—therefore also helping the economy. In other words, your economic growth numbers that you need to come up with, your projections I assume would be affected by that.

Then finally this notion of whether we have a long-term liability or not with regard to the trust fund. Couldn't you say in a sense that some of that liability is being prepaid—and this is what Mr. Walker indicated earlier—that in effect, what we are doing with part of this is we are prefunding a part of the Social Security obli-

gation, and in a sense, therefore, we are deferring some future liabilities.

I guess my specific question would be to you, you know, how would you analyze all of this? What would your economic growth projections be? How would they be affected by this? How would you analyze it in terms of your impact on the budget deficit as compared to other kinds of borrowings; and, you know, how you believe this—what you termed as qualitatively different kind of borrowing—would affect the economy?

Mr. HOLTZ-EAKIN. With the caveat that the details will matter, the rough template by which one would go through the analysis, I think, is fairly straightforward. The first would be to look at the difference from current law in the nature of the traditional benefits under Social Security, and what that looks like to individuals on a forward-looking basis: Are they getting a better or worse deal from the traditional program compared to what they could have expected under current law? That will inform their saving and labor supply decisions from that perspective alone.

The second would be to add in any individual accounts, and they would then make their decision about whether on the whole they have been made better or worse off in a financial sense by the reform. To the extent that every individual, say, on average, felt that they were better off, they would actually save less. By that, I mean, if they had more in their future and they were wealthier, they could consume more. If they felt that this increased their desire to save, we would see increases in personal saving. Then we would balance that against any change in the overall Government borrowing to look at what happens to national saving.

That, in the end, is the key determinant in the ability to finance capital accumulation, that grows the size of the economy. So we would have to trace through for individuals and for the Government the net impacts on their financial futures and look at the economic feedbacks, and we would do that. Starting with a projection of the future, you would layer on it the new program, you would analyze at the individual level the benefits they get out and taxes they would pay.

As you can imagine, all of this hinges critically on the nature of the reform, number one, but it also hinges critically on the baseline—in particular, for financial markets—the baseline perception of the outlook for Social Security.

To give you the outer bounds, one could think that the baseline perception of financial markets is the gap between benefits promised and benefits—revenues dedicated. That gap is wide and forever. That would be a daunting thing for financial markets.

Or they could take current law at face value and assume that after 2052 that closes. There is a very different baseline view of the outlook for Social Security depending on where you come down on that. We are actively engaged in talking with the financial markets and talking with experts in this area to see what their expectations are about the current program before you can analyze how they would react to any change.

Mr. PORTMAN. That is an interesting point and the behavioral model is interesting, too. But let me ask two questions.

One, with regard to the Social Security proposal as it has been laid out, whether it is the President's proposal or others that have been talked about in the past—Senator Moynihan's commission laid out a few different options—is it your sense that financial markets would react favorably or unfavorably to those kinds of options? And this is relevant not because financial markets determine what our entire economy is going to look like, but they do have a big impact on interest rates. You say you are going to run some of these ideas past some people who might reflect for you the financial markets. Don't you already have a sense of that one way or another, and what is it?

Mr. WALKER. Mr. Portman, if I can excuse myself.

I had mentioned to Chairman Nussle that I have got an oversight hearing before an oversight committee.

I would be happy to answer any questions that anybody might want to——

Mr. PORTMAN. Thank you for your testimony, Mr. Walker.

Mr. WALKER. Thank you.

Mr. PORTMAN. If you want to take a crack at this question before you leave, you certainly may.

Mr. WALKER. No, that is OK. I think I will let Doug answer it.

Mr. HOLTZ-EAKIN. We have some sense of it, but I would hesitate to give it a convenient summary. Here is the hard part—and this is shared by the financial markets and the CBO and anyone who with will look at this area ultimately—with a voluntary election reform—the real money depends on how many people participate.

The details then at the individual level about how this looks in terms of what they are going to get with their individual account, first, the unspecified-at-the-moment traditional program is a key part of how many people will take it; as a result, how much borrowing will be necessary to finance it and what the ultimate financial implications will be.

I would say the financial markets in the CBO are roughly in the same place at the moment, which is—we would really like to see the details before we make that call.

Mr. PORTMAN. If you assume that two-thirds of those people who would be available would take advantage of the personal accounts, you indicated that you would have to make certain assumptions about their saving behavior, so on. Wouldn't they feel safe—or less safe, and therefore save more or less—but wouldn't it have an independent impact on economic growth simply that by having the savings out there—it would be, as we know probably, in bonds, corporate bonds or in Treasuries or in some kind of an index Treasury account—doesn't have that have an impact on the economy independently?

Mr. HOLTZ-EAKIN. To a first-order effect, no, because it will be balanced by the borrowing at the Federal level and then borrowings in the financial market would be unchanged.

Mr. PORTMAN. Thank you, Mr. Holtz-Eakin.

We now have at least one more questioner, Mr. Cooper.

Mr. COOPER. Thank you, Mr. Chairman.

I apologize, I had a simultaneous hearing with Armed Services.

First, I think Republicans and Democrats would both agree that four of President Bush's primary initiatives, probably four initia-

tives that he will be judged by history on, would be the Iraq war, tax-cut permanency, Social Security reform, and the Medicare drug bill.

My chief of staff, Greg Hinote, thought this up. What do those completely different major initiatives have in common? The answer is, sadly, maybe tragically, none of those is accurately reflected in the President's budget.

We learned today that the Medicare drug bill was seriously underestimated. Social Security reform is completely ignored in the budget. The Iraq war is not funded beyond September 30th of this year. And for tax-cut permanency, apparently they are thinking about changing the budget rules, so the cost of that scored a zero.

Mr. HOLTZ-EAKIN. If I could, I would like to point out that Mr. Spratt and Chairman Nussle were given a copy of the testimony we wrote to Chairman Thomas of the Ways and Means Committee today about this question of whether the Medicare drug bill is, in fact, more expensive than originally estimated.

The answer to the question basically is no. I think that if one did an apples-to-apples comparison over the same budget windows, with the same components, we would estimate that it is about $6 billion more expensive than we anticipated. I don't think that the CMS estimates are radically different from that.

So I think for the record it is important to recognize that there has not been a lot of clarity about these cost estimates from the beginning, but it doesn't look like the bill is any more expensive at the beginning than it was at the outset.

Mr. COOPER. Even if we concede that point, three out of the four President's major initiatives are met, representing the budget, which almost makes a travesty of the operations of this committee. You know, we can talk about whether we are seeing 150 programs the President promises to cut and things like that; that is the small potatoes.

The big stuff, none of it is accurately represented in the budget, with the possible exception of the Medicare amendment. On Medicare, did you anticipate that Medicare was going to cover Viagra and other things like that in their medical benefits package? That was just in the news a week or two ago.

Mr. HOLTZ-EAKIN. Well, in our review of Medicare, to date we haven't changed our estimate very much. The most important, even in the young life of the MMA, is the issue of the final regulations. We are reading through the thousands of pages to see if the implementation matches what we envisioned when we did the cost estimate. The answer to that question will arrive with our estimate of the President's budget in March.

Mr. COOPER. Different line of questioning. I asked Secretary Snow if he had a valuation for the disability component of Social Security benefits. He did not give me an answer; said he would try to supply one. Do you have a valuation for the disability component of Social Security benefits or the survivorship death benefit component of Social Security benefits? What would that be?

Mr. HOLTZ-EAKIN. Our analysis includes all three components of the program. It includes the dollar values. I don't know them off the top of my head. We can certainly get them to you. They are buried in our reports.

I will point out that our numbers are the answer to the question: What do you get after the fact, given that you are disabled? The real valuation question is the insurance value if you don't know how it is going to turn out. We are still working, trying to put the best number on that.

Mr. COOPER. So you at CBO still do not have a valuation, an insurance valuation of those benefits?

Mr. HOLTZ-EAKIN. Not a broad social insurance value that—of the type that would be appropriate.

Mr. COOPER. As far as you know, are those benefits commercially available from any company in the United States?

Mr. HOLTZ-EAKIN. Not the type of benefit offered in the broad pool at Social Security.

Mr. COOPER. So, right now, would it be available for purchase nowhere else other than through the Social Security system?

Mr. WALKER. That benefit, no.

Mr. COOPER. Final question. What if in a Social Security compromise reform package some part of the corpus of the Social Security Trust Fund was invested in some sort of safe market investment as opposed to just Treasury securities? That would achieve some of the goals of the folks who advocate privatized accounts, wouldn't it, by enabling a better rate of return possibly to be achieved, rather than just the ultraconservative investment and Treasury instruments?

Mr. HOLTZ-EAKIN. It would have the same implications as the analysis of individual accounts. You have higher return at higher risk, risk is present.

Mr. COOPER. Only the risk would be spread across the society, as opposed to perhaps subjecting an individual who may have chosen unwisely—the risk would be spread, as opposed to individualized, right?

Mr. HOLTZ-EAKIN. The same total risk would be present. It could be distributed in many ways.

Mr. COOPER. Has the CBO done a study of that sort of Social Security reform?

Mr. HOLTZ-EAKIN. In the late 1990s, there were a series of studies looking at Social Security reforms, including looking at investments in private accounts. I don't know the names off the top of my head, but we would be happy to get what we have to you.

CBO PAPERS ON PRIVATE ACCOUNTS AND RELATED ISSUES

Social Security Privatization and the Annuities Markets (February 1998)

Letter to the Honorable Bill Archer regarding Professor Martin Feldstein's proposal to set up personal retirement accounts financed by tax credits (August 1998)

Social Security Privatization: Experiences Abroad (January 1999)

The Budgetary Treatment of Personal Retirement Accounts (March 2000)

Social Security: A Primer (September 2001)

Evaluating and Accounting for Federal Investments in Corporate Stocks and Other Private Securities (January 2003)

Social Security Reform: The Use of Private Securities and the Need for Economic Growth (January 2003)

Acquiring Financial Assets to Fund Future Entitlements (June 2003)

Administrative Costs of Private Accounts in Social Security (March 2004)

Long-Term Analysis of Plan 2 of the President's Commission to Strengthen Social Security (July 2004)

Long-Term Analysis of H.R. 3821, the Bipartisan Retirement Security Act of 2004 (July 2004)

Mr. COOPER. I thank the Chairman.

I see my time has expired.

Chairman NUSSLE [presiding]. Thank you, Mr. Cooper.

Mr. Davis for 5 minutes.

Mr. DAVIS. Thank you, Mr. Chairman. I don't mean to prolong Mr. Holtz-Eakin by coming in late, but I had multiple hearings going on also.

Let me go back to the line of questions I had with the Secretary, and I think it is an important policy to debate with this committee.

Obviously, I think there is very broad agreement if we wanted to fix, quote-unquote, the Social Security shortfall, we would have the fiscal capacity to do it by dipping into the tax cuts, if you will, by suspending a portion of the tax cuts. The argument against doing that is based on the theory that if we walk away from the tax cuts that it will retard the great rate of growth.

What I was exploring with the Secretary is that that has not empirically been the case in our economic history. In the 1990s—well, today as I understand it, the rate of corporate individual taxation as to GDP is around 15 to 16 percent; is that about right?

Mr. HOLTZ-EAKIN. I am sorry, say it again.

Mr. DAVIS. The rate of corporate individual taxation as to GDP is 15 to 16 percent of GDP today.

Mr. HOLTZ-EAKIN. We are at about 15 to 16 percent Federal receipts, a fraction of GDP.

Mr. DAVIS. OK. So about 15 to 16 percent, very low levels historically, lowest since World War II.

Now, we have also had—what has our growth been for the first half of this decade; growth of GDP for the first half of this decade?

Mr. HOLTZ-EAKIN. I don't know the number off the top of my head. It runs through a recession, then a recovery.

Mr. DAVIS. But you would certainly say less than the 1990s when we had a robust recovery.

Mr. HOLTZ-EAKIN. Yes.

Mr. DAVIS. And in the 1990s, we had a taxation rate—combined corporate rate plus income—of around 21 percent, 22 percent; you would agree with that?

Mr. HOLTZ-EAKIN. Only at the end. Tax receipts as a fraction of GDP edged above 20 percent toward the end of the 1990s, largely driven by the equity-based income taxation.

Mr. DAVIS. Was there any point where it dropped as low as 16 percent during the 1990s?

Mr. HOLTZ-EAKIN. No.

Mr. DAVIS. At the time of greatest growth in the 1990s; what would those years have been, 1996 to 2000 roughly, or 1996 to 1999?

Mr. HOLTZ-EAKIN. Yes.

Mr. DAVIS. What was the rate of taxation from 1996 to 1999 as to GDP?

Mr. HOLTZ-EAKIN. Well, it rose during that period.

Mr. DAVIS. OK.

Mr. HOLTZ-EAKIN. Receipts as a fraction——

Mr. DAVIS. OK. So obviously higher than the 16 percent we have today, conservatively higher. You would agree with that.

Mr. HOLTZ-EAKIN. Yes.

Mr. DAVIS. So we can conclude from the 1990s that a higher tax rate did appear to retard growth. Go back to the 1960s, when you and I were born, we had a very high—what some people thought was a confiscatory rate of taxation—corporate-based income was 28 or 29 percent in the 1960s, wasn't it?

Mr. HOLTZ-EAKIN. Rates were much higher in the 1960s.

Mr. DAVIS. So as to GDP it would have been 28 to 29 percent.

Mr. HOLTZ-EAKIN. No, as a fraction of GDP it wasn't that high.

Mr. DAVIS. OK. Was it higher than 16 percent?

Mr. HOLTZ-EAKIN. The GDP number will be the average taxes raised. Economic behavior is going to be driven by marginal tax rates. We have seen big shifts across this period in average rates between individuals and corporations and the structure of the individual rates across that.

So I am sympathetic to your point that not just taxes drive economic performance. I think that is absolutely right. I guess what I would also point out at the outset is in thinking about this in the context of Social Security, it is important to discuss what constitutes a fix.

The reason I raise this is that in our projections scheduled benefits are about 2 percentage points above scheduled receipts as a fraction of GDP. On the long term, the tax cuts are about 1.4 percentages points of GDP.

So if one wants to fix Social Security in a cash-flow sense, so that it never intervenes with the rest of the Federal budget, it requires a larger fix than the one you are discussing.

If one wants to fix it in an actuarial sense, those numbers are typically smaller, but they require a simultaneous effort on the part of this committee, and in particular on the Congress in general, not to touch funds that are dedicated from the remainder of the budget to Social Security.

Mr. DAVIS. So let me cut you off, because my time is expiring.

Mr. HOLTZ-EAKIN. So I know what the fix means here.

Mr. DAVIS. Yes, I think that is an important distinction.

But since my time is low, let me ask another point. Let us assume hypothetically we were to take the short-term approach as you describe it, and that we were to draw down the tax cuts, if you will, to deal with the temporary shortfall projected in Social Security.

Wouldn't there be a commensurate rise in consumer and investor confidence that might make up for any lost confidence because some of the tax cuts were being repealed?

Mr. HOLTZ-EAKIN. First of all, we will have to figure out what "temporary" means. But let us leave that aside. I think the problem is as far as the eye can see.

Mr. DAVIS. I guess I am asking a fairly narrow proposition, then.

Mr. HOLTZ-EAKIN. But if you ask what will happen to financial market confidence, you know, long-term interest rates reveal no lack of confidence at the moment in U.S. Treasury securities.

Mr. DAVIS. Let me slip in another quick question in the last 15 seconds.

Another thing that I asked the Secretary about was the basis for the projections around the shortfall by 2042. I thought the Secretary initially agreed with me and with the Social Security Administration that the projected growth of the GDP over that period of 30-some years was around 1.8 percent. Then he seemed to say that it wasn't the GDP, it was the level of productivity.

Can you weigh into that and tell us what is accurate? Is the President's estimate of the shortfall based on 1.8 percent productivity or 1.8 percent GDP between now and 2042?

Mr. HOLTZ-EAKIN. Long-term GDP projections are usually put together by counting the number of bodies that will be available, growth in the labor force, and then how much more productive each body will be. Those are the two basic building blocks.

Mr. DAVIS. OK.

Mr. HOLTZ-EAKIN. Over the long term, the key movement is not in productivity which remains, in those projections and in ours, pretty solid over the long term and similar to history. The key aspect is the slower growth in the labor force. That is present even in our 10-year budget projections where GDP growth averages 3.4 percent up to about 2010 and then drops to 2.7 percent. That is the retirement of the baby boom, that is fewer people coming into the labor force. It reflects the fact that over the long term the native population is below replacement fertility.

So it is true that the fundamentals are in the same good historical shape they were, but the bodies to which they were being applied are diminishing as we go forward.

Mr. DAVIS. Let me—and I don't want to push my luck on the time—but just to push this to its logical conclusion, taking all of that aside—and that is not exactly what Secretary Snow said. I have probably been on your accuracy over his, given your impartiality as opposed to his.

But let us assume that 1.8 percent number over 30-some years—would that not be a lower number than the growth that we have enjoyed, for example, than we have enjoyed over the last 30 years?

Mr. HOLTZ-EAKIN. Yes, it would be.

Mr. DAVIS. OK. And would that not likely indicate that the stock market possibly would not perform as robustly as we would want it to? I mean, he argued that there was—he rejected that correlation. Can you comment on that?

Mr. HOLTZ-EAKIN. Yes, I think there is no reason to automatically assume there is a bad stock market going forward. The fundamentals——

Mr. DAVIS. There is no reason to assume either way, is there?

Mr. HOLTZ-EAKIN. No, I think that there is no reason to dramatically change your view of the future of returns to equities based on that number in any way. I mean, if the productivity numbers are about the same, if the productivity numbers are about the same, productivity drives profitability and the pricing in the market. While we can fiddle at the edges with the number, I think qualitatively those projections and the ones we do are all in line.

Mr. DAVIS. OK. Thank you Mr. Chairman.

Chairman NUSSLE. Thank you, Mr. Davis.

There has been a discussion—while you are still here to be able to respond—we did discuss yesterday this issue of the percentage

of Federal receipts as to GDP and determined that, in fact, if the permanence goes forward—in other words, there is no change in our current tax policy—which is assumed in the budget, by the way, per Mr. Cooper—that the percentage would rise. I believe it was to 17.2 percent. I can't remember the number. So you will have an increase in your percentage of GDP, even with tax permanence.

Thank you, Dr. Holtz-Eakin for your testimony today. We appreciate your coming before us again. We look forward to working with you on Social Security and the budget.

No further questions for you.

We are going to move on to the next panel.

Mr. HOLTZ-EAKIN. Thank you.

Chairman NUSSLE. We are pleased to be joined now by Dr. Peter Orszag.

Dr. Orszag is a senior fellow at the Brookings Institution. He is also a retirement policy expert, one with whom I have agreed and disagreed, but always respect his work.

Dr. Orszag, thank you for being with us. We have had a long day. As you can see, we have lost a few members to other hearings.

But if you would please proceed after we have an opportunity for my colleague, the ranking member, to make any introductory remarks.

Mr. Spratt, I already welcomed him.

Mr. SPRATT. Dr. Orszag, Mr. Orszag, thank you very much for coming, and, more than anything, thank you for your forbearance. We are sorry you had to wait so long. We will let you be the cleanup hitter and we expect you to hit it out of the park.

Thanks for your interest and thanks for coming and your excellent contributions.

Chairman NUSSLE. Dr. Orszag.

STATEMENT OF PETER R. ORSZAG, PH.D., SENIOR FELLOW, THE BROOKINGS INSTITUTION

Mr. ORSZAG. Thank you. I want to make four or five points, and I would emphasize that there are a lot of details that have not been filled in yet, but those that we do have are insightful—and even more insightful when I turn on my microphone.

First, under the administration's proposal, workers who opt for individual accounts would pay back that diverted revenue plus 3 percent interest at retirement through reduced Social Security benefits.

In many ways this is quite similar to a loan. The worker receives cash up front, gets to invest that money, but then has to pay back the principal plus interest later. In many ways, again, this is quite similar to a loan. The form of repayment is not critical to the underlying nature of the transaction.

Let me give you a specific example. Someone in high school today, who would turn 21 in 2011, could put $500 in 2011 into his or her account, $1,000 in 2015, et cetera—these are all inflation-adjusted dollars—but would also owe a debt back to Social Security at retirement at age 65 in 2054 of roughly $150,000.

So that worker, just like with borrowing money, that worker winds up better off only if his or her account exceeds that $150,000. It is worth noting that under the administration's assumptions, if

the worker did invest in bonds, in Government bonds, that account would only grow to $142,000, less than the $150,000 debt owed back to Social Security. The reason is that the administrative costs on the accounts open up a wedge between the Government bond rate and the net return to the individual.

Of course, this is not a—this analogy should not be taken literally. There is not a contract involved in this transaction. But nonetheless, it is a very useful analogy. Basically the outcomes are equivalent to someone borrowing money at a 3 percent real interest rate, with the repayment undertaken through reductions in traditional Social Security benefits.

Second point. The administration itself has said that there is a net neutral effect from this proposal on the solvency of Social Security. And viewing it from the prism of a loan, one can see why the Treasury rate is assumed to be 3 percent. If you loan money at 3 percent, and you are borrowing at 3 percent, it is a wash as long as the loan is fully repaid. But I want to emphasize that that is actually the best possible outcome, because there are many situations in which these implicit loans will not be fully repaid. Let me give you a few examples.

First, the administration has highlighted that if you would die before retirement, your account will pass to an heir. A key question is what happens to the liability associated with that account? Does that also pass to your heir, in which case the bequest is a mixed blessing; the young will inherit both an account and a debt.

Under the President's Commission models, all that happened was the account was passed along, not the debt. That means Social Security and the Federal Government is out that money.

Similarly, there are many workers who work for less than 40 quarters or 10 years. They don't have any traditional Social Security benefits because they are not eligible for retirement benefits under the current program. They have no traditional benefit under which to offset the cost of the diverted revenue plus interest. And you can keep going down the line.

There are a variety of situations in which—at least based on the specification we have seen to date—the situation, the accounts would actually make solvency worse, not better, even over the infinite horizon that the administration prefers. That conclusion is only strengthened over the 75-year horizon that is traditionally used.

Third point. It has already been emphasized that there is a significant increase in public debt associated with these accounts.

I want to point out that that increase is a permanent increase in the very long term if just the accounts by themselves raise public debt as a share of GDP by about 25 to 30 percent of the economy. The reason is that even if each individual loan is eventually repaid through reductions in Social Security benefits, at any point in time there are always some loans outstanding. That means that public debt is always higher than in the absence of the accounts.

Now, there was a discussion earlier about whether this matters, about whether that is just trading one form of debt, public debt, for another form which is future benefit promises.

I would argue that it does matter. I don't know any country that has gotten in trouble or had trouble, a financial crisis, because of

a high implicit debt; that is, large future benefit promises. I know of many that have gotten in trouble with a large explicit debt.

Trading implicit debt for explicit debt is not a neutral transaction. Explicit debt has to be financed in the financial markets. It has to be rolled over. Arguing that a dollar of debt today doesn't really matter, because we will have a dollar less public debt in present value in 50 or 60 years, I think is a problematic argument in the real world. It works in economic theory; it doesn't work in real-word financial markets.

My final point is that because the accounts do not do anything to improve long-term solvency, and likely harm it, there are other changes that will be necessary to restore solvency to Social Security. If there is no additional revenue dedicated to the program, there are very severe benefit reductions that have to occur in order to eliminate the deficit.

So if you combine the benefit reductions that are tied to the accounts, and then add on top of that the benefit reductions that are necessary under the administration's type of approach to eliminate the long-term deficit in Social Security, the traditional program truly withers on the vine over time.

Take that young worker I already talked about. The traditional benefit would go from replacing 36 percent of previous wages to 7 percent of previous wages, a dramatic decline, roughly a fifth of the current-law benefit. Now, that worker would have an account which could make up part of the difference. But if you use the Congressional Budget Office analysis, it does not make up the full difference, so there are very substantial benefit reductions that are entailed in these accounts, plus trying to eliminate the long-term deficit in Social Security.

My final point would be—my view is that we do need individual accounts. We already have them, they are called 401(k)s and IRAs. Mr. Portman has been one of the leaders of building savings in the areas of those vehicles. I think that is where our attention should be in terms of building wealth and ownership. There is a growing body of evidence about what works there. It is not necessary to mortgage future Social Security benefits to increase account ownership.

PREPARED STATEMENT OF PETER R. ORSZAG, JOSEPH A. PECHMAN SENIOR FELLOW, THE BROOKINGS INSTITUTION[1]

Mr. Chairman, thank you for inviting me to testify before you this morning. On February 2, the Bush Administration released some details about its proposal to replace part of Social Security with individual accounts. Even with these admittedly incomplete details, several points now appear clear:[2]

- Under the Administration's plan, payroll taxes deposited into an individual account are essentially a loan from the government to the worker. The Administration's proposal is the equivalent of a loan that mortgages future Social Security benefits: Workers opting to divert payroll taxes into an account today would pay back those funds, plus interest, through reductions in Social Security benefits at retirement.[3] In other words, just as with a loan, the worker receives cash up front and then owes money back, with interest, later. Someone who borrows money to make an investment benefits if the assets purchased with the borrowed funds grow faster than the debt; the person is worse off if the debt grows faster than the investment. Similarly, under the Administration's plan, workers wind up with higher retirement income if the income from their accounts exceeds the benefit reductions that pay off the loan, and vice versa.
- The accounts not only fail to reduce the Social Security deficit, but will likely increase it. Even an Administration official has acknowledged that the accounts pro-

posed by the President would have a "net neutral effect" on Social Security's financial condition over the long term. The reality is likely to be even worse, however: The accounts will likely harm Social Security's long-term deficit. The reason is that not all the "loans" from diverted revenue will be repaid in full; in several situations, which I will describe below, subsequent benefit reductions will be insufficient to offset the cost of the diverted revenue plus interest. As a result, even over the "infinite horizon" that the Administration favors, the accounts not only fail to reduce the deficit in Social Security; they make it worse. Over the traditional 75-year horizon used to evaluate Social Security solvency, this conclusion is only strengthened.

- The accounts by themselves entail a significant and sustained increase in public debt. By themselves, the individual accounts would increase public debt by more than $1 trillion during the first decade they were in effect and by more than $3.5 trillion during their second decade. The increase in public debt, moreover, would be permanent: Even if each individual "loan" were eventually repaid in full, public debt would remain higher than in the absence of the accounts over the long term. The reason is that even if each loan were eventually repaid, some loans will always be outstanding. As a result, the government will never, at any point in time, yet have been paid back for all the revenue diverted into accounts—and therefore public debt will always be higher than without the accounts. The bottom line is that the Administration's account proposal would raise public debt by more than 30 percent of GDP over the very long term. And even if the account proposal were combined with other measures that (unlike the accounts) would reduce the deficit in Social Security, public debt would remain higher than in the absence of the plan for several decades. Such higher levels of public debt are problematic because they increase the exposure of the government to a collapse in financial market confidence.
- The Administration's ultimate plan will have to rely on severe benefit reductions to eliminate the Social Security deficit. Since by the Administration's own admission the accounts do not reduce Social Security's deficit, and since the Administration is opposed to dedicating additional payroll taxes to the program, the Administration's plan to eliminate the long-term deficit in Social Security must involve severe reductions in benefits (or introduce some new revenue source for the program). In particular, any plan that closes the deficit, includes the accounts the Administration has already proposed, and fails to dedicate additional revenue to Social Security must involve substantial cuts in traditional benefits beyond those required to pay back the loans to workers opting for individual accounts.[4] The combined effect would be a stunning decline in the defined benefit component of Social Security over time. For example, if one prominent type of benefit reduction (often referred to as "price indexation ") were combined with the loan repayments necessary under the Administration's accounts, traditional benefits for a young average earner today could decline drastically—instead of replacing more than a third of the worker's previous wages, Social Security's defined benefits would replace well under a tenth.

Building ownership and wealth should not come at the expense of mortgaging future Social Security benefits. Nor should Social Security reform be associated with a significant increase in public debt: such an increase is not necessary to reform Social Security or even to create individual accounts. Furthermore, the accounts in the Administration's plan by themselves would not increase national savings, and could end up reducing it (if individuals decide to contribute less to their 401(k)s and IRAs because they see other money accumulating in their individual account).[5]

A better approach would shore up the existing Social Security system while raising saving in addition to Social Security. Several common-sense steps could substantially boost saving outside of Social Security.

THE LOAN ANALOGY

Under the Administration's proposal, the individual account system would involve two components: the individual account assets, which would contain a worker's deposits and the accumulated earnings on them, and a "liability account." If a worker chose to participate in the individual account system, 4 percent of payroll taxes (initially up to a limit of $1,000, with the limit gradually eased over time) would be diverted into the account, accumulate during the worker's career, and be available to the worker upon retirement.[6] Since the revenue diverted to this account would reduce the financing available to the traditional Social Security system, a "liability account" would also be created. This liability account would track the amounts diverted, and accumulate them at a 3 percent real interest rate. The liability account would determine the debt owed back to Social Security at retirement because of the diverted funds.

Upon retirement, the worker's debt to the Social Security system would be repaid by reducing his or her traditional Social Security benefits—that is, the monthly

check paid to a retiree. Specifically, the monthly benefit reduction would be computed so that the present value of the reduction would equal the accumulated balance in the liability account. In other words, the reduction in monthly benefits would be just enough, in expected present value, to pay off the accumulated debt to the Social Security system.

This system is quite similar to a loan: As under a loan, the worker receives cash up-front and can invest the money. The worker pays back the borrowed funds, with interest, later. The specific form of the repayment, through a reduction in traditional Social Security benefits, does not alter the underlying nature of the transaction.[7]

To take a specific example, consider a medium-earning worker aged 21 at the beginning of 2011 who elects to participate in the accounts. In inflation-adjusted dollars, the worker would divert about $500 in payroll taxes into his or her account in 2011, about $1,000 in 2015, about $1,500 in 2020, and so on. Those funds would build, along with the investment returns on them, and be available to the worker upon retirement. This worker would also, however, incur a debt to Social Security that would accumulate to more than $150,000 by the end of 2054, when the worker would be 65.[8] Repayment of the $150,000 debt to Social Security would consume roughly half of the worker's retirement benefit under the current benefit formula.[9]

If the assets in the worker's account upon retirement exceed $150,000, the worker would experience a net increase in retirement income, and vice versa, compared to not participating in the account.[10] Thus the worker's retirement income, on net, increases if the account yields 3 percentage points per year above administrative costs and inflation. The worker's retirement income declines if the account yields less than that.

Note that because of administrative costs, it is impossible for the worker to break even while holding government bonds and for the government to be held harmless on the transaction. The reason is that one party or the other must bear the administrative costs of the investment. Under the Administration's assumptions, for example, the real interest rate on government bonds is 3 percent per year. Under that assumption, the system would hold the government harmless as long as the worker reached retirement and paid back the loan (the government would be held harmless since the loan carries the same real interest rate as the projected government borrowing rate). The worker, however, would be worse off if she opted for an account and held government bonds in it. Such an account would have a net real yield of 2.7 percent per year (the 3 percent real return on government bonds minus the assumed 0.3 percent per year in administrative costs), leaving the worker with a net reduction in retirement income. The worker's account in this case would grow to only about $142,000, or almost $10,000 less than the worker's debt of more than $150,000 back to Social Security.

Although the loan analogy is insightful in understanding the basic effects of the proposal, there are some important distinctions between a conventional loan and the proposed system. For example, under the Administration's proposal, workers must make a one-time decision to participate in the accounts; after that initial decision, they are required to continue diverting revenue over the rest of their careers.[11] (The ability to invest the additional borrowing in Treasury bonds does not necessarily insulate the worker from the effects of the borrowing, given administrative costs and the possibility that the realized interest rate on government bonds may in the future diverge from the interest rate on the "loan." ") Conventional loans do not typically require the borrower to continue borrowing over time. In addition, the proposed accounts carry restrictions that are not typical of conventional loans: The Social Security loan can only be used for purchasing assets such as stocks held until retirement, and can only be repaid in a specific form (through a reduction in future Social Security benefits).[12] Finally, unlike a conventional loan, this transaction would presumably not involve a contract.[13] Despite these important distinctions, the loan analogy is useful in evaluating the impact of the proposal.

ACCOUNTS DO NOT IMPROVE SOLVENCY AND LIKELY HARM IT

The loans to workers opting for the accounts carry a 3 percent real interest rate. This rate is equal to the expected real interest rate on government bonds projected by the Social Security trustees in their intermediate cost assumptions. Since the interest rate on the loans is equal to the interest rate that the Social Security system is assumed to earn on its own funds, the system is held harmless on each individual loan, under the trustees' assumptions, as long as the loans are repaid in full. This is why a senior Administration official was quoted on February 2 as saying, "So in a long-term sense, the personal accounts would have a net neutral effect on the fiscal situation of the Social Security and on the Federal Government." A reporter than

asked: "And am I right in assuming that in the way you describe this, because it's a wash in terms of the net effect on Social Security from the accounts by themselves, that it would be fair to describe this as having—the personal accounts by themselves as having no effect whatsoever on the solvency issue?" The senior Administration official replied: "That's a fair inference."[14]

Two crucial points are worth noting about this statement. First, even the Administration now acknowledges that the accounts do nothing to reduce the long-term deficit in Social Security. In other words, according to the Administration itself, individual accounts are simply a non-answer to the question of how the deficit in Social Security will be addressed.

Second, the statement by the Administration official is likely to be incorrect: The accounts are likely to harm Social Security's solvency. The reason is simply that there are several likely situations in which the loan repayment back to Social Security (through reduced Social Security benefits) would be insufficient to offset the cost of the diverted revenue. Only if repayment is always made in full will the Administration official's statement prove to be correct. If repayment is incomplete in some circumstances, the accounts not only fail to reduce the Social Security deficit, they actually widen it.[15]

Several likely scenarios suggest that at least some of the loans will not be repaid in full, and therefore the accounts will harm the system's long-term finances:

- Pre-retirement deaths. If a worker dies before retirement without a living spouse, the amount in the individual asset account may be distributed to heirs, but the amount in the individual liability account could be extinguished. This is how the system worked under the proposals put forward by the President's Commission to Strengthen Social Security in 2001; the Administration has apparently not clarified whether the same approach would be adopted now. Under this approach, some loans are not paid off—and the system is thus made financially worse off. The effect may be significant, since roughly one-seventh of workers die before retirement. (The alternative is to have the debt inherited along with the account. In that case, the Administration should clarify that the pre-retirement bequests facilitated by the accounts may be a decidedly mixed blessing: the heirs will inherit both an account and a debt.)
- Backsliding on loan repayments. The benefit reductions necessary to pay off the "loans" from Social Security—especially if combined with additional benefit reductions to improve solvency—may be so large that they could prove politically untenable over time. For example, retirees may pressure the government to reduce the loan repayments during periods of weak stock market performance. If such pressures were accommodated and full loan repayments not enforced, the actuarial effect of the accounts could be negative over an infinite horizon.
- Traditional benefits insufficient to finance loan repayment. Even without political pressure to reduce loan repayments, some repayments may be curtailed simply because the traditional defined benefit component of Social Security is too small to pay back the loan in full. In other words, for some workers, the required benefit reductions may exceed the size of the traditional defined benefit part of Social Security that is supposed to provide the repayment financing.[16] In such a situation, the loan would apparently not be repaid in full; in other words, workers would apparently not be forced to repay debts back to Social Security that exceed their traditional benefits. An extreme version of this could arise for workers with less than 10 years of covered earnings, who do not even qualify for Social Security retirement benefits. Such workers would have no traditional benefit against which to apply the loan repayment. If someone working for, say, 5 years were allowed to keep his or her account, the loan may never be repaid, since the worker would not have any traditional benefits with which to repay it. Again, the net result from these types of situations would be that the accounts harm Social Security solvency over the long term.
- Interest rate on Trust Fund more than 3 percentage points above inflation. The interest rate on the loan to workers is apparently specified as 3 percentage points above inflation. That holds the Social Security system harmless on each individual loan, assuming each is repaid in full, as long as the interest rate actually turns out to be 3 percentage points above inflation. But if real interest rates turn out to be higher than 3 percent, the system would not be compensated sufficiently for the diverted funds, and the accounts would widen the Social Security deficit. It is therefore noteworthy that the Congressional Budget Office assumes a long-term real interest rate on government bonds of 3.3 percent.[17] In other words, under CBO assumptions, the Administration's proposal (with a 3 percent real rate charged on the loans to workers) would harm solvency even over an infinite horizon. If real interest rates on government bonds turn out to be lower than the 3 percent rate applied to the loans, the opposite would be true.

These effects mean that even over the problematic infinite horizon preferred by the Administration, the accounts may harm solvency. That conclusion is only strengthened over the 75-year horizon traditionally used to evaluate Social Security solvency. Over that 75-year horizon, the accounts unambiguously widen the deficit even if all loans are ultimately repaid in full. (The reason is that some loans issued over the next 75 years will not have been repaid by the end of the 75th year.)

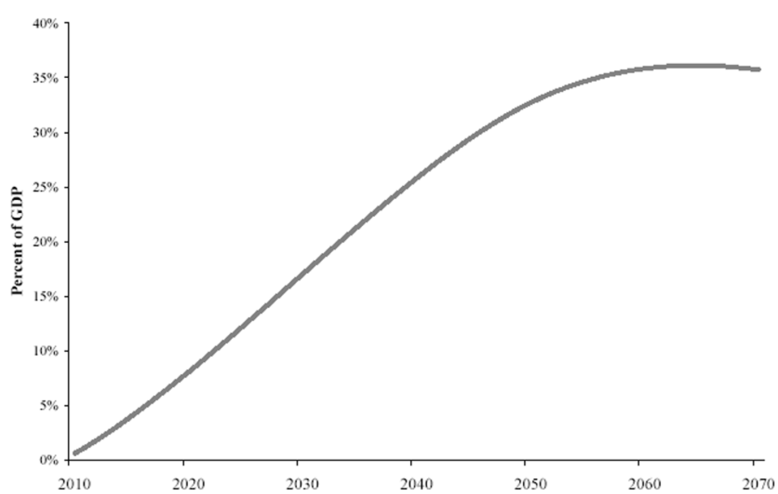
ACCOUNTS ENTAIL A SIGNIFICANT INCREASE IN PUBLIC DEBT

According to a memorandum from the Office of the Chief Actuary, the Administration's accounts would raise debt held by the public by $743 billion as of the end of Fiscal Year 2015.[18] The increase in debt, moreover, would not subside thereafter: If the accounts were continued past 2015, they would raise debt by more than $3.5 trillion by 2025.[19] Over the first 10 years that they were in existence (2009-2018), the accounts would raise debt by more than $1 trillion; during their second decade (2019-2028), they would raise debt by more than $3.5 trillion.[20] (There has been some confusion over $743 billion figure and the more than $1 trillion figure. The $743 billion figure applies to the next 10 years. The more than $1 trillion figure applies to the first 10 years the accounts would be in existence, from 2009 through 2018.)

The loan analogy helps to explain this increase in debt, and it also provides insight into a surprising result: The debt increase would be permanent. To finance a loan to a worker (provided in the form of revenue deposited into an individual account) under the Administration's proposal, the government borrows funds. If the worker repays the loan, the additional government debt on that transaction is extinguished, so public debt returns to the same level as if that worker had not opted for an account. But note that at any point in time, even if all loans were eventually repaid, some loans would always be outstanding. As a result, public debt at any point in time would forever remain higher with the accounts than without them.

Figure 1 illustrates the impact of the Administration's accounts on debt held by the public. Three aspects of the figure are noteworthy. First, debt increases sharply as a share of Gross Domestic Product (GDP) for roughly five to six decades. Second, the higher level of debt is perpetuated, rather than eliminated, in the long term. Finally, the additional, ongoing higher level of debt in the long term is substantial—the increase in debt outstanding of more than 30 percent of GDP is only somewhat smaller than today's level of publicly held debt relative to GDP (38 percent).

Figure 1: Increase in debt held by the public due to Administration's accounts



Even if the accounts were combined with proposals to eliminate the underlying deficit in Social Security, the increase in debt is likely to be extended and substantial. For example, the leading proposal from the President's Commission to Strengthen Social Security in 2001 would have changed the determination of indi-

vidual benefits to incorporate what is commonly—but somewhat misleadingly—referred to as "price indexing."[21] The change may sound innocuous, but as explained below, it would dramatically reduce benefits over time. For the immediate purpose, note that price indexation is sufficient by itself to more than eliminate the long-term deficit in Social Security. Yet even if the accounts proposed by the Administration were combined with this price indexing proposal, debt held by the public would remain higher than in the absence of the combined proposal for roughly five decades.

Some advocates of the Administration's plan argue that the debt shown in Figure 1 merely creates "explicit debt" in exchange for "implicit debt" that the government has already incurred (in the form of future Social Security benefits). From this perspective, advocates argue that the loan transactions merely trade more explicit debt for a reduction in implicit debt (since the loan repayments will reduce future Social Security benefits). The argument is then put forward that these two types of debt—"implicit debt" and "explicit debt"—are essentially the same, so that converting one into the other does not represent an increase in Federal liabilities and should not raise concerns.

This argument is, however, flawed. The two types of debt are not equivalent. The explicit debt that the government would incur as a result of the Administration's proposal for individual accounts would have to be purchased by creditors in financial markets. When the additional debt matured, it would have to be paid off or rolled over. By contrast, the implicit debt associated with future Social Security benefit promises does not have to be financed in financial markets now. A government with a large explicit debt thus has less room for maneuver and is more vulnerable to a lessening of confidence on the part of the financial markets than a government with a large implicit debt. Converting implicit debt into explicit debt is thus problematic.

SUBSTANTIAL BENEFIT REDUCTIONS NECESSARY TO ELIMINATE LONG-TERM DEFICIT

Since the accounts do not reduce Social Security's deficit (and may expand it), and since the Administration appears to be opposed to dedicating additional payroll tax revenue to the program, the Administration's approach to eliminating the long-term deficit in Social Security must involve some new source of revenue dedicated to the program or rely on severe reductions in benefits beyond the loan repayments linked to the accounts. In other words, any plan from the Administration that closes the deficit, includes the accounts it has already proposed, and fails to dedicate additional revenue to Social Security must entail two types of benefit reductions. The first type of benefit reductions would repay the loans to workers opting for the accounts. The second type would be intended to eliminate the long-term deficit in Social Security. The combined effect of these two types of benefit reductions would be a stunning decline in the defined benefit component of Social Security over time.

To examine the impact of relying solely on benefit reductions to eliminate the underlying deficit in Social Security, consider the proposal from Model 2 of the President's Commission in 2001. This proposal would have changed the determination of individual benefits to incorporate "price indexing," instead of the wage indexing that is currently used to determine initial benefits. Had this "price indexing" rule been fully in effect by 1983, at the time of the last major reform to Social Security, benefits for newly eligible retirees and disabled workers now would be almost 20 percent lower and continuing to decline relative to current law. These benefit reductions would apply regardless of whether a worker elected to participate in the individual accounts.

Under current law, benefits for new retirees roughly keep pace with wage growth.[22] Successive generations of retirees thus receive higher benefits because they had higher earnings—and paid higher payroll taxes—during their careers. This feature of the Social Security system makes sense, since a goal of Social Security is to ensure that a worker's income does not drop too precipitously when the worker retires and ceases to have earnings. A focus on how much of previous earnings are replaced by benefits (which is called the "replacement rate ") recognizes the real-world phenomenon by which families, having become accustomed to a given level of consumption, experience difficult adjustment problems with substantial declines in income during retirement.

Under what is called price indexing, by contrast, initial benefit levels upon retirement would increasingly lag behind wage growth. In particular, real benefit levels would be constant over time, rather than increasing in line with real wages. Since real wage growth is positive on average, the change would reduce initial benefit levels and the size of the reduction would increase over time.[23]

Under this proposal, if average real wages were 10 percent higher after 10 years, the roughly 10 percent benefit growth to keep pace with this wage growth would simply be removed. The provision thus is more accurately described as "real wage

growth negating" than as "price indexing," since it simply cancels the benefit increases from real wage growth.[24]

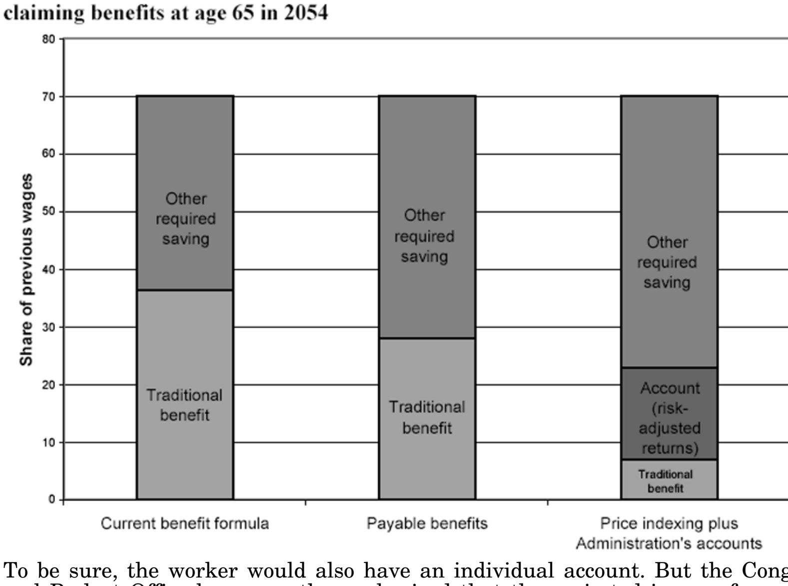
Several commentators have underscored the troubling consequences that would result from "price indexing." Edward Gramlich, a leading economist who chaired the Advisory Commission on Social Security in the mid-1990's and who is now a governor of the Federal Reserve System, has been quoted as saying that if this methodology had been adopted when Social Security was created, [retirees] "would be living today at 1940 living standards."[25] An earlier analysis of the proposal underscored that: "This is like saying retirees who could afford indoor plumbing when they were working should, in retirement, not be able to afford indoor plumbing because their parents' generation could not afford it."[26] Even some leading proponents of the Administration's broad approach have acknowledged this point. For example, John Goodman, president of the National Center for Policy Analysis, recently commented about the price-indexing proposal: "What people are forgetting is why the system is there in the first place. The reason is that people don't want to reach retirement age and have their standard of living cut in half."[27]

Two implications of reducing benefits to cancel out real wage growth are immediately obvious. First, the longer the "price indexing" provision stays in effect, the larger the benefit cuts, assuming ongoing real wage gains. Second, the more rapid real wage growth, the larger the benefit cuts.[28]

The bottom line is that under "price indexing," the role of the Social Security system in allowing the elderly to maintain their standard of living after retirement would decline sharply over time.

Consider the effect of the price indexing proposal combined with the loan repayment for workers opting for the accounts put forward by the Administration. Specifically, as above, consider a medium earner who is 21 in 2011, and assume the worker claims benefits at age 65 in 2054. Given the economic assumptions used by the Congressional Budget Office, price indexing would first reduce this worker's retirement benefit by more than 35 percent.[29] Then the loan repayment for the revenue diverted into the worker's account would consume about half of the benefit provided by the current benefit formula. As a result, the worker would have a traditional benefit equal to less than one-fifth of the benefit provided by the current benefit formula.

Figure 2: Initial replacement rates at retirement for medium-earning worker claiming benefits at age 65 in 2054



To be sure, the worker would also have an individual account. But the Congressional Budget Office has correctly emphasized that the projected income from such accounts must be adjusted for its riskiness. With the type of risk adjustment adopted by the Congressional Budget Office, the income from the individual account would make up about half of the initial benefit under the current formula.[30] The

net result would leave the worker with total combined benefits that were roughly 35 percent lower than under the current benefit formula.

Perhaps more surprisingly, the reduction in benefits even including the account income is roughly twice as large as would be required if benefits in 2054 were simply reduced to match incoming payroll revenue in that year. This level of "payable benefits" is about 20 percent higher than the income from the account plus the remaining traditional benefit after price indexing and the loan repayment, under the type of assumptions used by the Congressional Budget Office.

Figure 2 illustrates these effects in terms of the replacement rate at retirement in 2054. Financial planners suggest that a comfortable retirement requires income during retirement equal to about 70 percent of pre-retirement earnings. The current benefit formula would provide about half the necessary amount, requiring the worker to save enough in addition to Social Security to replace roughly 35 percent of pre-retirement earnings. If benefits were reduced to match incoming payroll revenue in 2054, traditional benefits would replace a little under 30 percent of pre-retirement wages, requiring the worker to save a little more than 40 percent of previous earnings.[31] If the Administration's accounts were combined with price indexing, however, the traditional benefit after both price indexation and the loan repayment were applied would replace less than 10 percent of previous wages. The income from the individual account would replace a little under 20 percent of previous wages. The net result would be that the worker would have to save substantially more in addition to Social Security; such savings would have to be enough to replace almost half of pre-retirement earnings.

Figure 2 shows that combining price indexing with the loan repayments on individual accounts would cause the traditional benefit to wither on the vine over time.

CONCLUSION

Individual accounts that mortgage future Social Security benefits raise a number of troubling questions, as this testimony has highlighted. A better approach involves raising saving above and beyond Social Security. As illustrated in Figure 2, individual accounts—in the form of the 401(k)s and IRAs—have a critical role to play in filling the hole between the foundation provided by Social Security and a comfortable retirement. Many Americans, however, have not accumulated enough financial assets on top of Social Security. Half of households on the verge of retirement have only $10,000 or less in a 401(k) or IRA. Yet we now know what works to get people to save in 401(k)s and IRAs, and we're not doing it.

Individual accounts can and should be strengthened outside Social Security, where they belong. Social Security itself can then be shored up through a combination of benefit and revenue changes that would retain the program's critical role in delivering a solid foundation of financial security.[32]

ENDNOTES

1. The views expressed here are those of the author alone. This testimony draws upon joint work with Peter Diamond, Jason Furman, William Gale, and Robert Greenstein. For a detailed discussion of the issues involved in payouts from individual accounts, see National Academy of Social Insurance, Uncharted Waters: Paying Benefits from Individual Accounts in Federal Retirement Policy, 2005.

2. The Administration still has not specified many important aspects of the accounts. I have tried to reflect the proposal as I understand it, based on official White House documents and on the memorandum from the Office of the Chief Actuary. In some cases, however, these documents contradict each other. As more details about the proposal become available, some of the specific figures cited in this testimony may be slightly affected, but the fundamental points will not be. For other analyses of the Administration's proposal, see Jason Furman, "New White House Details Show the Proposed Private Accounts Would Worsen Social Security's Finances," Center on Budget and Policy Priorities, February 4, 2004; Jason Furman and Robert Greenstein, "An Overview of Issues Raised by the Administration's Social Security Plan," Center on Budget and Policy Priorities, February 3, 2004; and Jason Furman, "How the Individual Accounts in the President's New Plan Would Work: Plan Would Allow Individuals to Mortgage Half of Their Social Security Benefit," Center on Budget and Policy Priorities, February 4, 2004.

3. Although the system operates like a loan, it is not literally a loan because the transaction does not involve a contract. For some purposes, such as budget scoring, the fact that the transaction does not involve a contract and therefore is not legally a loan may be determinative. For further discussion of the budget scoring issues involved in proposals of this type, see Jason Furman, William G. Gale, and Peter R.

Orszag, "Should the Budget Exclude the Cost of Individual Accounts?" Tax Notes, January 24, 2005.

4. Such a plan would entail two types of benefit reductions: those that would apply only to workers opting for the accounts, which would be intended to repay the loan to the worker, and benefit reductions that would likely apply to all future workers, regardless of whether they opted for an account, which would be intended to eliminate the long-term deficit in Social Security.

5. Specifically, if individuals understand that the individual accounts are equivalent to a loan, they may not reduce their other savings. But if they do not understand the nature of the offsetting benefit reduction, then they may mistakenly consider the individual account an asset and reduce other asset accumulation accordingly.

6. The limit would increase by $100 above wage inflation, at least through 2015. The Office of the Chief Actuary, in its memorandum on the proposal, indicated that the parameters of the system past 2015 had not been specified. It is noteworthy, however, that the White House Fact Sheet indicates that: "Under the President's plan, personal retirement accounts would start gradually. Yearly contribution limits would be raised over time, eventually permitting all workers to set aside 4 percentage points of their payroll taxes in their accounts." Given this statement, the analysis in this testimony assumes that the threshold would continue to increase more rapidly than wages until all workers could contribute 4 percent of taxable earnings. None of the qualitative conclusions are affected by this specific assumption.

7. In effect, the individual accounts proposed by the Administration represent a "Social Security line of credit." Workers drawing upon that line of credit receive payroll revenue in their individual account today, but must pay back the funds at retirement.

8. Since the worker was 21 at the beginning of 2011, he or she would turn 22 during 2011. The worker would therefore turn 65 during 2054.

9. Note that the worker would be diverting less than one-third of the Social Security payroll tax into the account, but the benefit reduction would total roughly one-half of the benefit under the current benefit formula. The reason is that the loan is correctly charging the marginal return on funds within the Social Security system, not the average return.

10. The outcome is identical to the worker borrowing from future Social Security benefits at a 3 percent real interest rate. The worker benefits only if the return to the assets purchased with the borrowed funds exceeds 3 percentage points above inflation. As emphasized in the text, because of administrative costs, the worker would have to earn more than 3 percentage points above inflation on the underlying investments in order to break even; the net return above inflation and after administrative costs must be 3 percent per year to break even.

11. As the White House Fact Sheet put it, "At any time, a worker could "opt in" by making a one-time election to put a portion of his or her payroll taxes into a personal retirement account. Workers would have the flexibility to choose from several different low-cost, broad-based investment funds and would have the opportunity to adjust investment allocations periodically, but would not be allowed to move back and forth between personal retirement accounts and the traditional system." (See below:)
http://www.whitehouse.gov/infocus/social-security/200501/socialsecurity3.pdf.

12. It is unclear whether these restrictions would be sustainable. Most workers currently enjoy some form of access to the balances in their 401(k) accounts prior to retirement. A critical question regarding the Administration's proposal is whether Congress would sustain the prohibition on pre-retirement access even if it were initially adopted. Workers will likely argue that they should indeed have earlier access. At the beginning, such an argument may be made only in hardship cases—such as a terminal disease. Over time, this might evolve into withdrawals for education or first-time home purchases, or into an ability to borrow against an account. Such pre-retirement liberalization would then severely undercut the role of Social Security as financing retirement.

13. As noted in a footnote above, this distinction may be determinative for the purposes of budget scoring.

14. Transcript of briefing as posted on Washington Post website:
http://www.washingtonpost.com/ac2/wp-dyn/A59045-2005Feb2?language=printer.

15. In theory, one could construct the system so that those actually repaying the loans overpaid, in order to compensate for the losses from those who underpaid. But this would impose even greater costs, beyond the administrative cost issue noted in the text, on workers who elected the accounts and then held bonds in them until retirement.

16. The example provided in the text above suggested that a medium-earner's loan repayments back to Social Security could represent about half of the benefit under the current benefit formula. For higher earners, the pay-back on the loan would be an even higher share of benefits under the current benefit formula. Compared to the reduced benefits that would exist under the Administration's approach to restoring solvency in Social Security, furthermore, the loan repayments would be even larger.

17. Congressional Budget Office, "Updated Long-Term Projections for Social Security," January 2005, Table W-5, *http://www.cbo.gov/Spreadsheet/6064—Data.xls.*

18. "Preliminary Estimated Financial Effects of a Proposal to Phase in Personal Accounts—INFORMATION," Memorandum from Stephen C. Goss to Charles P. Blahous, February 3, 2005.

19. These figures, like the ones in the memo from the Office of the Chief Actuary, assume two-thirds participation in the accounts.

20. Such increases in debt would occur even if the maximum account size were capped at its (wage-adjusted) 2015 level, rather than continuing to be increased more rapidly than wages after 2015 to ensure the White House goal that all workers could eventually contribute 4 percent of payroll to the accounts.

21. This approach has also been employed in legislation introduced by Senator Lindsey Graham. As noted below, it is more accurately called "real wage growth negating" than "price indexing," since it removes the impact of real wage growth on benefit levels, rather than incorporating a price index directly into the benefit formula.

22. Initial retirement benefits are based on a worker's average indexed monthly earnings. Average indexed monthly earnings, in turn, are determined by taking earnings in previous years and scaling them up by subsequent national average wage growth. The wage indexing occurs through the year in which a worker turns 60, with later wages used on a nominal basis (unindexed). The initial benefit level is thus indexed to wage growth through age 60. After initial benefit determination, benefit increases are indexed to price growth. Price indexing of benefits begins after the year in which a worker turns 62. Thus there is a gap with no indexing to either wages or prices, which should be corrected—and could be addressed on a revenue-neutral basis if desired. The formula relating full benefits (the so-called Primary Insurance Amount) to earnings is also indexed to average earnings. In 2005, the Primary Insurance Amount is equal to 90 percent of the first $627 of AIME; 32 percent of AIME over $627 and through $3,779; and 15 percent of AIME over $3,779. The "bend points" at which the 90, 32, and 15 percent factors apply are indexed to wage growth.

23. The 2004 Trustees Report projects long-run growth of prices of 3.0 percent per year and long-run growth of taxable wages of 4.1 percent per year, resulting in a growth of real wages of 1.1 percent per year. But real wage growth may turn out to be larger or smaller than this amount.

24. More precisely, the proposal would multiply the 90 percent, 32 percent and 15 percent factors used to compute the Primary Insurance Amount by the ratio of cumulative price growth to cumulative wage growth between the start date and the year in which a worker becomes entitled to claim benefits. It is thus important to note that wage indexing would still be part of the determination of benefits.

25. Greg Ip, "Social Security: Five Burning Questions," Wall Street Journal Online, December 19, 2004.

26. "Price-Indexing the Social Security Benefit Formula Is a Substantial Benefit Cut," prepared by the minority staff of the Social Security Subcommittee, House Committee on Ways and Means, November 30, 2001.

27. Cited in Edmund L. Andrews, "Most G.O.P. Plans to Remake Social Security Involve Deep Cuts to Tomorrow's Retirees," New York Times, December 13, 2004.

28. This second implication may not be widely understood: The proposal reduces benefits more if real wage growth is more rapid than expected. Yet if real wage growth is more rapid, the actuarial deficit over 75 years in the absence of this provision would be smaller, not larger. The use of real wage negating is thus even more troubling than simply reducing benefits based on expected real wage growth today. The larger actual real wage growth turns out to be, the smaller the need for benefit reductions—but the larger those reductions actually are under the real wage negating approach. In other words, the approach introduces variation in benefit reductions relative to scheduled benefits that are larger the less the financial need of Social Security for such reductions.

29. The figure assumes that price indexing applies to workers who are 54 years old and younger in 2005.

30. The risk adjustment implemented by the Congressional Budget Office is consistent with the approach adopted by the Administration in evaluating stock invest-

ments by the National Railroard Retirement Investment Trust. As the Analytical Perspectives of the Administration's Fiscal Year 2006 budget notes (page 421), "Economic theory suggests...that the difference between the expected return of a risky liquid asset and the Treasury rate is equal to the cost of the asset's additional risk as priced by the market."

31. The CBO assumptions show a cost rate in 2054 of 6.39 percent of GDP and an income rate of 4.95 percent of GDP. A benefit reduction of 23 percent (1-4.95/6.39) would thus reduce cost to income. A reduction of 23 percent compared to the current benefit formula would leave this worker with a replacement rate from Social Security of roughly 28 percent (.77*.36).

32. For one plan that achieves sustainable solvency without the severe benefit reductions implied by price indexing, see Peter A. Diamond, and Peter R. Orszag, Saving Social Security: A Balanced Approach (Washington: Brookings Institution Press, 2004).

Mr. PORTMAN [presiding]. Thank you, Dr. Orszag, for your testimony. I appreciate the fact that you have spent so much time on not just the Social Security side but retirement security generally. And I, as you know, happen to agree with you that we need to do both additive. I also find I disagree with you with regard to the possibility of doing something within Social Security as well.

Just a couple of quick questions about your testimony, first with regard to administrative costs. You indicate that that is the major reason you would see the 3 percent, which you note is the bond rate that has been used in some of the analysis, not being—not leading to someone with a personal account to have a much higher rate of return than someone, say, entering the workforce today, which I think the estimate is about 1.8 percent return. What do you assume by the administrative cost? Do you believe the administration's numbers that they had out last week of a 30 to 40 basis point administrative cost.

Mr. ORSZAG. In that calculation, I did assume the 30 basis point number that the administration has used. So that is the assumption that I used. I do want to comment on that for a second, though, because that administrative cost assumption assumes a very centralized type of account in which investment choices are restricted. There are a variety of restrictions. It is not clear to me that that ultimately will be sustainable given the way these accounts are being sold, And if you have a more decentralized system where you can hold the accounts at any financial services firm, the administrative cost could be much higher.

Mr. PORTMAN. But you basically take the Thrift Savings Plan model and think that, assuming that they were that regulated and that centralized, that that administrative cost could be that low.

With regard to your second point, I agree with you, there are some unanswered questions here. You didn't mention the annuitization of the funds but you talked about the liability that is reflected in the choice to take a personal account and if someone were to predecease their retirement age that that account would then be, as some have said, available for kids and grandkids, family. It is also relatively easy under the Social Security system to determine what that liability would be, isn't it? In other words, couldn't you come up with a calculation as to what the liability is with regard to that account going forward at any particular age and be able to provide that personal account as a lump sum in addition to whatever the liability was?

Mr. ORSZAG. Yes. My only point there was—and again we are talking about roughly 14 percent of the workforce dying before re-

tirement. To talk about only the bequests either raises the question of these accounts actually harming the solvency of Social Security even over an infinite horizon or the hidden subtext that there will be a debt passed on along with the account. That was my only point.

Mr. PORTMAN. But it is not impossible to make that calculation?

Mr. ORSZAG. That is correct.

Mr. PORTMAN. The 40 quarters issue is an interesting one, because some people don't make 40 quarters, therefore they don't get the traditional benefit. Do you think it would be appropriate for those people to have a personal account at all?

Mr. ORSZAG. Again, an unanswered question. I mean, presumably what would happen is that the accounts would not be delayed until after you had worked 40 quarters. So I guess the question is, are you confiscating the accounts, or are the deposits not going in?

Mr. PORTMAN. That is a good point.

Mr. ORSZAG. I was going to say, there is another situation that I think is worth paying attention to in which the traditional benefit would not be sufficient to pay back the diverted revenue plus interest. That is, if you combined this proposal with price indexing, which is the leading way of actually—leading proposal apparently to restore solvency within the traditional program for the top end of the income distribution (and it is not a trivial share, we are still working on the numbers but it is not 1 or 2 percent of the workforce, much higher than that), the traditional benefit would not be sufficient to offset the cost of the diverted revenue plus interest. That means the system would actually lose money for any high earners who went into the accounts because the traditional benefits just wouldn't be there—be sufficient to pay back the diverted revenue plus interest. And there are a wide variety of these kinds of situations that could arise.

Mr. PORTMAN. Your third point was that with no new revenue you need to look at the benefits side. Do you have a favorite proposal?

Mr. ORSZAG. I think there are a variety of proposals on both the benefit and revenue side. I have co-authored a plan with Peter Diamond of MIT. That is one way of doing it. We tried to balance or combine benefit and revenue changes. One can move beyond just talking about the payroll tax, and I know there is some discussion of that. One could talk about dedicating a state tax revenue or dedicating various different kinds of revenue to the system.

The key point is without any additional revenue dedicated to the program you are looking at very substantial reductions in replacement rates or reductions relative to the current benefit formula to restore solvency to the program beyond, in my opinion, what is justified for that core tier of retirement security.

Mr. PORTMAN. One of the interesting things as you look at our tax system and how it relates to Social Security is the fact that, as you know, many workers, low-wage workers, even some low to middle wage workers do not have a personal individual income tax liability; some in fact get a tax check back from the Government through the EITC, earned income tax credit. Therefore, to look at retirement as you and I have from the outside as it affects Social Security, it is difficult without offsetting payroll taxes in the way

the President is talking about to affect those people who you most want to encourage to save, and that would be lower income workers, middle income workers who do have a payroll tax liability. And so my challenge to you would be, as much as I agree with you on the individual accounts, as you know, and even on the savers credits and so on, how do you get at the solvency of Social Security with these outside accounts? And, number two, how do you really help the low wage worker who for the most part does not have an income tax liability, therefore a tax deduction, a tax credit is not useful?

This is one thing that I think needs to be looked at. And as you know, I believe in the individual accounts, I also believe we ought to do much more on the 401(k) and the IRA side and even some new vehicles. But using that payroll tax does provide certain advantages that you don't have given the fact that increasingly under George Bush's leadership fewer people are paying Federal income tax and the burden is shifting more to the upper end. So it is harder to use the income tax, Federal income tax to effect savings among lower and middle income workers. Can you give us a response to that?

Mr. ORSZAG. Sure. Let me answer that second question first and then come back to solvency. I actually think the whole way that we have been trying to encourage savings in the United States, private savings, is wrong, that trying to do it through financial incentives is not the most auspicious mechanism for raising savings. The fact of the matter is most families are busy, they don't focus on the decision. The decisions to save are complicated, and so there is a lot of inertia and just delaying the decision. If you put in plans where, for example, you are automatically in a 401(k) plan unless you opt out, which alters that inertia decision, participation rate even at the very bottom, below $20,000 in income, jumped from about 7, it shows, from 15 percent to 80 percent. Similarly, outside of 401(k) plans I think we just need to make it more automatic. Get those tax refunds automatically into an IRA, set up payroll deduction IRAs in a more universal way. I will even say, I mean, even at Brookings—give you an example, a little personal example. Because of changes in the 2001 tax law, the amount that—the maximum amount that can be put in a 401(k) or a 403(b) is increasing each year and increased this year. We got a form at Brookings saying if you wanted to put in the maximum amount this year you need to fill out this form. If you don't fill it out, you are going to stay at the lower level from last year. I would bet that half of my colleagues have not filled out that form. They just lose it. We need to make the whole process more automatic so that the default is that you are always saving. I would sign up for saving the maximum amount for the rest of my life until I tell someone otherwise, and I think many of my colleagues would also. The same thing. I think we just need to make it more automatic. We are looking in the wrong way when we—families that are too busy to focus on the decisions will still be too busy to focus on the decisions when we throw more financial incentives at it.

So that is my answer. I don't think that we should attack the problem primarily through financial incentives. They can help, but the big thing is to get the structure right.

And in terms of the solvency of Social Security, the way I think about it is the following. Financial planners say that we need 70 percent of preretirement income to live comfortably in retirement. Social Security for the average earner is providing about a half of that, 35 percent; the other half happens to come from the sorts of things we were just talking about. I think that bottom tier, that foundation should be provided in a form that lasts as long as you are alive; that is, protected against inflation and that doesn't fluctuate with the stock market. And that is exactly what the current program does. So in my view, while there might be some benefit adjustments that are necessary, taking that 35 percent replacement rate and going all the way down to 20 for young workers and then even further below that, which is what would be happening under price indexing, is not a very sound approach. So I have a proposal that avoids that kind of outcome. There are lots of ways of avoiding that kind of outcome. But I don't see individual accounts within that core tier as providing the kind of benefit that they can provide above that core tier.

Mr. PORTMAN. I appreciate your answer. I know that at least one proposal that you support it, and I admire your courage, raises payroll taxes which, as you know, is something the President has ruled out and I don't think would be very popular here on the Hill. And also it has some negative economic impacts. Others have talked about using general revenues, which is in essence not allowing the taxes to become permanent that are currently in place, the tax relief. So I do appreciate your stepping forward with a proposal. But I would just say I think the challenge we have got is how do you link this notion of higher private savings and the private vehicles with our solvency? And with that I will turn to my colleague and ranking member, Mr. Spratt.

Mr. SPRATT. Mr. Portman, I don't know if you have seen the book, but Peter Orszag has worked his way through all of these problems in a very commendable fashion to come up with a proposal that I think has been reduced to legislation. Hasn't it, Peter?

Mr. ORSZAG. Not to my knowledge. It has been scored by the Social Security actuaries and also by the Congressional Budget Office though.

Mr. SPRATT. In it you develop the idea of a legacy debt, that Social Security owes for the overpayment of benefits in past years, particularly when the early employees retired after not having put a full 40, 35 years into the system but nevertheless drew, relatively speaking, pretty substantial benefits. Would you elaborate upon that?

Mr. ORSZAG. Sure. And, in fact, this comes back to Mr. Portman has asked about the rate of return for current generations of 1 or 2 percent on Social Security, why is that any lower than the Government bond rate of 3 percent. And it has to do—precisely to do with the legacy debt that you mentioned. Early retirees under Social Security were given rates of return that were well above market rates of return. Think about it, someone had paid in for 5 or 10 years and then received benefits for perhaps 20 or 30 or 40 years. By the way, that decision was probably a good one. These people had lived through the Great Depression, fought in World War I and World War II, that that decision probably from society's

perspective made sense. But because we gave away excess returns early, we all now collectively face the prospect of having to pay off again what we call that legacy debt.

The legacy debt comes because we gave away excess returns under the program early, and there is nothing that we can do to erase that debt. I mean, a lot of these comparisons of rates of return pretend that we can just erase that debt. Right now what that would mean in practice is cutting off current beneficiaries. That is the only real way that we can erase the debt. And then of course their rates of return would be harmed. We gave away that money or we made a decision as a society to provide super normal rates of return. That is now water under the bridge and we all must face it.

That is the difference, and I think economists on both sides of the aisle agree on this. That is the reason that Social Security provides a 1 to 2 percent rate of return and the Government bond rate is 3 percent, and there is nothing we can do at this point to take back the money that we had given away early on.

Mr. SPRATT. You propose, however, a rectification in your book.

Mr. ORSZAG. Well, I think the key thing is that is water under the bridge. We all now collectively have to face the fact that we are all going to have to finance that in some way, and the key question is how do we share that burden. There are extremes. You could put off reform for a long period of time and have far distant generations bear an undue burden. You could move immediately to a fully funded system which would require current workers to bear the full burden. We think those two extremes don't make any sense and that something in between does.

So I guess there are really two points here. One is, this is a key underlying issue in Social Security reform. And it is not issue—it is not sort of—it doesn't bubble to the surface enough how different generations are sharing that burden.

The second thing is any plan will distribute that burden in some way, and it is very important to look at how the burden is being distributed.

And just a final point, and I guess this come back to the individual accounts. Individual accounts are often pitched as helping young workers today. That is sort of where the natural pitch is made to. But the fact of the matter is if the individual accounts were honestly financed; that is, through additional revenue or offsetting changes today, the young workers today are the ones who bear that legacy debt. They are the ones who bear that transition cost. Or another way of putting it is they are the ones who have to pay twice. They will have to pay for current beneficiaries and then for their own retirement. So focusing on the legacy debt illuminates questions like that; much of the rhetoric surrounding the debate obscures it.

Mr. SPRATT. Let me ask you about the 75-year time frame as opposed to the infinity time frame. You deal with that in your book, and you come down on the side of sticking with the 75-year time frame primarily because projecting so far over the horizon and into the future is terribly tenuous.

Mr. ORSZAG. I think it is illuminating that out of the $10.4 trillion infinite horizon imbalance, more than 60 percent of it occurs

after 2078; that is, between 2078 and eternity. And while I think it is important that we are aware of how sensitive the projections are out in 2100 or 2200, I don't think that it is the best basis for policy making. It is just too sensitive. If we change the discount rate from 3 percent to 2.9 percent or the interest rate from 3 percent to 2.9 percent, and that number swings all over the place. So if that is the goal that you are trying to hit, I worry that reasonable changes in the parameters cause you to be chasing your tail.

Mr. SPRATT. Extended out over a long period of time?

Mr. ORSZAG. Extended out beyond the traditional 75-year window.

Mr. SPRATT. Discuss with us for a minute what happens to disability payment if we have the significant disability and survivorship benefits. You may have heard the exchange earlier with Secretary Snow.

Mr. ORSZAG. I did.

Mr. SPRATT. If indeed you recompute the primary insurance amount, indexing the income streams to prices rather than wages as they are indexed today, and over time reduce the replacement ratio by 50 percent, what does this do to the 30 percent of those who are on Social Security and are drawing either survivorship or disability benefits?

Mr. ORSZAG. Well, let me answer the question in two different ways. Under the President's commission model 2 and model 3, the reductions that you are describing were assumed to apply, or at least in their numbers they assume that they applied to disabled workers, to young surviving children, to a whole variety of other very vulnerable beneficiaries. The implication of that is very severe reductions in benefits for the most vulnerable set of beneficiaries under Social Security.

Now, the administration currently says that there will be no changes in the disability component or the survivor's component of Social Security. I would just warn you that to say that there are no changes in the disability component is not necessarily to say that there are no changes in disability benefits, and the President's commission danced around that question. I think it is a very important topic and something that policymakers like all of you need to pay a lot of attention to, to look in the fine print about exactly what is happening to those beneficiaries.

Mr. SPRATT. Now, let me ask you about the proposal in model 2, which I presume will be an integral part of the President's proposal once it is fully formulated, to recompute the primary insurance amount using prices instead of wages to index the income streams. We showed a chart earlier that shows how the replacement ratio for the median beneficiary declines by about 50 percent, from 43 percent of preretirement income to 22 percent of preretirement income over a period of 40 or 50 years. That also includes the return that would—the net return that that beneficiary would receive in his collateral savings account, whatever it is called. With a return at a rate equal to the bond rate, which is 3 percent real rate of return, how much would the rate of return have to be in the collateral account for the PIA or the replacement ratio to remain constant?

Mr. ORSZAG. First, just to give you the numbers, the Congressional Budget Office analysis of model 2, which is the one that you are referring to, makes it very clear that even including the individual account and even comparing to payable benefits, not scheduled benefits, model 2 pays less than what the system could afford even after the trust fund is exhausted and benefits were reduced to match incoming payroll revenues. So, in particular, table 2 of their analysis shows that in the middle household earnings quintile, or for basically the typical household in the middle of the distribution, that lower level of payable benefits would be $19,900 a year. Model 2 would give $14,600 a year, including the individual account as analyzed by CBO. So that is roughly a $5,000 a year differential, a very substantial amount for a typical family. To make up that difference would require an implausibly large rate of return on stocks as long as you are assuming some mix between stocks and bonds.

Mr. SPRATT. Of what magnitude? Can you give us a ball park figure?

Mr. ORSZAG. Above 10 percent real on a sustained basis, assuming a 60/40 split.

Mr. SPRATT. So to be held harmless, so to speak, the account would have to make above 10 percent, and that is after the clawback of 3 percent real?

Mr. ORSZAG. Just to be clear, that is on the stock component, and then of course there is the bond component, too. Stocks would have to be yielding well in excess of their historical average.

Mr. SPRATT. But is that after the deduction of 3 percent——

Mr. ORSZAG. Yes, I am sorry. That is net of the benefit offset.

Mr. PORTMAN. OK. So you have to make well above 10 percent on the whole account?

Mr. ORSZAG. Again, just to repeat, you need to make more than 10 percent on the stock component. The bond component would then be accruing at the interest rate that CBO assumes. After all of that, subtracting the benefit offset, you would just make back up to the 19,900 only if stocks were yielding well above 10 percent real, which again is substantially higher than their historical average.

In other words, under CBO's assumptions it is unlikely that you would get back the payable benefits. And in fact you can see that in the CBO analysis. If you look at figure 3B, they show you the range of uncertainty over benefits compared to the payable benefits baseline. And out in the outyears, even with 80-percent probability, one would—plus or minus 40 percent on either side, you are not getting back to payable benefits. So it is a very small probability that you will get back even to payable benefits let alone to the current benefit formula under CBO's assumptions.

Mr. SPRATT. Now, let me ask you. Have you had an opportunity to run the numbers on what amount of debt accumulation would be necessary, at least in the first 20 years, to float model 2 or to float a proposal based upon that, particularly if the diversion is four points off FICA as opposed to two points off FICA?

Mr. ORSZAG. Yes, and I think this chart actually shows you. This shows you as a percent of GDP. But just to give you the numbers in dollars, starting from when the accounts actually begin in 2009,

the first decade they are fully—or, in effect; they are not even fully in effect. The first decade they are in effect the additional debt would be more than $1 trillion. And then in the second decade it would be more than $3.5 trillion. The details will matter—will depend a little bit on whether we should take a briefing from a senior White House official at face value in suggesting that the accounts will ultimately grow to 4 percent of earnings and exactly how that happens. But that is the order of magnitude that we are talking about.

Mr. SPRATT. About $4.5, $4.6 trillion over the first 20 years of implementation?

Mr. ORSZAG. Correct.

Mr. SPRATT. OK. Do you have any opinion as to what that would do to—you have heard the discussion today. Is that debt, or is that something else, since we supposedly have a wash here, that we are only prepaying future obligations and that financial markets will treat this differently? What is your view of what that sort of debt accumulation will do to the budget and to the economy?

Mr. ORSZAG. I think we are running an increasing risk over time of running into problems, rolling over our debt, and maintaining the confidence of investors. Implicit debt and explicit debt are different things. Implicit debt does not have to be rolled over in financial markets. By issuing the trillions of dollars in additional explicit debt, we are increasing the risk that we run into problems with financial market confidence, in my view.

And just to rephrase that, the consequences of a collapse in financial market confidence are more extreme, and the probability of that diminution in financial market confidence seems to me higher when we trade future implicit debt for current explicit debt.

Mr. SPRATT. Thank you very much.

Mr. PORTMAN. Well, I believe Mr. Cuellar has now left us, so Dr. Orszag, thank you very much for your testimony. It was an interesting exchange. I will say that you talked about some CBO numbers that we don't have yet, and we are eager to get them. When we look at the potential range of benefits as a share of GDP, we are getting some different numbers based on some projections that we have, but we do not have all the numbers you have. So we are looking forward to those.

Mr. ORSZAG. This is with regard to model 2.

Mr. PORTMAN. I am not sure that we would entirely agree with the 80 percent range of uncertainty number that you listed based on model 2. But in any case we will have more of those figures as this debate goes forward.

Mr. SPRATT. Mr. Chairman.

Mr. PORTMAN. Mr. Spratt.

Mr. SPRATT. Can I take a second to tout his book, Saving Social Security, published by Brookings, Diamond and Orszag. I guess you can find it on their web page.

Mr. ORSZAG. You can indeed.

Mr. SPRATT. An excellent discussion of all of this.

Mr. PORTMAN. Mr. Spratt, you really should be holding up a 1-800 number. That would be more——

Mr. SPRATT. If I had it, I would.

Mr. PORTMAN. Or something dot.com.

Anyway, Peter, thank you very for your testimony today, and with that our hearing is adjourned.

[Whereupon, at 2:41 p.m., the committee was adjourned.]

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